MAR 24 1986

Y 4. T 19/4: T 19/117

ORIGINAL.

COMPLETED
462

[JOINT COMMITTEE PRINT]

# TAX REFORM PROPOSALS IN CONNECTION WITH COMMITTEE ON FINANCE MARKUP

March 18, 1986

JCS-8-86

58-215 O

U.S. GOVERNMENT PRINTING OFFICE 1986

COD

[JOINT COMMITTEE PRINT]

# TAX REFORM PROPOSALS IN CONNECTION WITH COMMITTEE ON FINANCE MARKUP

March 18, 1986

JCS-8-86

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402

I

# CONTENTS

Page

**I. Individual Income Tax Provisions** 1

- A. Basic Rate Structure 1
  - 1. Tax rate schedules 1
  - 2. Zero bracket amount (standard deduction) 1
  - 3. Personal exemption 2
  - 4. Limitation on tax-liability reduction for highest-bracket individuals attributable to personal exemptions and certain itemized deductions 3
  - 5. Two-earner deduction 4
  - 6. Earned income credit 4
  - 7. Income averaging 4
- B. Tax Treatment of the Elderly and Disabled 5
  - 1. Exemption for the elderly 5
  - 2. Credit for the elderly 5
  - 3. Wage replacement benefits 6
- C. Scholarships and Fellowships 8
- D. Deductions for Personal Expenditures 9
  - 1. Itemized deduction for certain State and local taxes 9
  - 2. Charitable deduction for nonitemizers 9
  - 3. Adoption expenses 9
  - 4. Deductibility of mortgage interest and taxes allocable to tax-free allowances for ministers and military personnel 10
- E. Expenses for Business or Investment 11
  - 1. Travel and entertainment expenses 11
  - 2. Employee business expenses, investment expenses and other miscellaneous itemized deductions 14
- F. Political Contributions Tax Credit 15
- G. Presidential Campaign Checkoff 15

**II. Accelerated Cost Recovery System and Investment Tax Credit** 16

- A. Depreciation 16
  - 1. Accelerated incentive depreciation system 16
  - 2. Alternative cost recovery system 18
  - 3. Indexing 19
  - 4. Accounting conventions 19
  - 5. Gain on disposition 19
  - 6. Lessee leasehold improvements 20
  - 7. Repair allowance 20
  - 8. Expensing 20
  - 9. Vintage accounts 20
  - 10. Public utility property 20
  - 11. Effective date 21
- B. Windfall Recapture of Excess Accelerated Depreciation 22
- C. Regular Investment Tax Credit 22
  - 1. Allowable credit 22
  - 2. Public utility property 22
  - 3. Effective date 22
- D. Mandatory Refund of Unused ITC Carryovers 23
- E. Finance Leases 23
- F. Multi-Family Residential Rental Housing Credit 23

Page

**III. Accounting** 24

- A. Simplified Dollar Value LIFO Method for Certain Small Businesses 24
- B. Limitations on the Use of the Cash Method of Accounting 24
- C. Installment Sales 25
- D. Capitalization of Inventory, Construction, and Development Costs 26
  - 1. Inventory 26
  - 2. Self-constructed property and noninventory property produced for sale 26
  - 3. Long-term contracts 27
  - 4. Interest 27
  - 5. Effective date 27
- E. Special Treatment of Certain Items 28
  - 1. Reserves for bad debts 28
  - 2. Returns of magazine, paperbacks and records 29
  - 3. Qualified discount coupons 29

**IV. Capital Gains** 30

- A. Individual Capital Gains 30
- B. Corporate Capital Gains 30
- C. Incentive Stock Options 30
- D. Small Business Participating Debentures 31
- E. Straddles 32
  - 1. Mark-to-market system 32
  - 2. Year-end rule for qualified covered calls 32

**V. Compliance and Tax Administration** 33

- A. Increased Penalties 33
  - 1. Penalties relating to information returns 33
  - 2. Penalty for failure to pay taxes 33
  - 3. Negligence and fraud penalties 34
- B. Interest Provisions 34
  - 1. Interest rate 34
  - 2. Underpayments of accumulated earnings tax 34
  - 3. Interest on tax refunds 34
- C. Information Reporting Provisions 35
  - 1. Reporting on real estate transactions 35
  - 2. Reporting on persons receiving Federal contracts 35
  - 3. Reporting of State and local income and property taxes paid by individuals 35
  - 4. Tax-exempt interest required to be shown on tax returns 35
- D. Suspend Statute of Limitations During Prolonged Dispute With Third Parties 36
- E. Tax Shelters 36
  - 1. Tax shelter user's fee 36
  - 2. Tax shelter registration 37
  - 3. Penalty for failure to register a tax shelter 37
  - 4. Penalty for failure to report the tax shelter identification number 37
  - 5. Penalty for failure to maintain lists of investors 38
  - 6. Tax shelter interest 38

Page
F. ESTIMATED TAX PAYMENTS BY INDIVIDUALS 38
G. TAX LITIGATION AND TAX COURT 39
  1. Awards of attorneys fees in tax cases 39
  2. Exhaustion of administrative remedies 40
  3. Tax Court provisions 40
H. TAX ADMINISTRATION PROVISIONS 41
  1. Authority to rescind statutory notice of deficiency 41
  2. Authority to abate interest due to errors or delays by the IRS 41
  3. Suspension of compounding where interest on deficiency is suspended 42
  4. Exemption for levy for service-connected disability payments 42
  5. Modification of administrative rules applicable to forfeiture 42
  6. Certain recordkeeping requirements 42
I. MODIFICATION OF EMPLOYEE WITHHOLDING ALLOWANCE FORMS 43
J. REPORT ON RETURN-FREE TAX SYSTEM 43
K. DECREASE PERIOD OF TAX DEFERRAL FOR TRUSTS 44
L. PAYMENT OF INCOME TAXES OF ESTATES 44

**VI. Corporate and General Business Taxation** 45

A. IN GENERAL 45
  1. Corporate tax rates 45
  2. Corporate dividends paid deduction 45
  3. Corporate dividends received deduction 46
  4. Dividend exclusion for individuals 46
  5. Stock redemption payments 46
  6. Limitations on net operating loss (NOL) carryovers 47
  7. Recognition of gain or loss on liquidating sales and distributions 50
  8. Modification of merger and acquisition rules 53
  9. Miscellaneous subchapter C changes 57
  10. Extraordinary dividends received by corporate shareholders 58
  11. Ordinary income treatment on sales between related entities 58
  12. Holding period requirement for dividends received deduction 59
  13. Amortizable bond premium 59
B. RAPID AMORTIZATION PROVISIONS 60
  1. Five-year amortization of trademark and tradename expenditures 60
  2. Five-year amortization of pollution control facilities 60
  3. Fifty-year amortization of qualified railroad grading and tunnel bores 61
  4. Deduction for loss in value of bus-operating authorities 61
C. DEDUCTIBILITY OF FEDERAL EXCISE TAXES AND TARIFFS 62
D. OTHER CAPITAL-RELATED COSTS 63
  1. Marine Capital Construction Fund 63
  2. Limitation on business tax credits 63
  3. Contributions in aid of construction 63

Page
**VII. Energy, Agriculture, Timber, and Natural Resources** 64

A. AGRICULTURAL PROVISIONS 64
  1. Special expensing provisions 64
  2. Farming and ranching costs 64
  3. Netting for cooperatives 65
  4. Treatment of certain plant variety protection certificates as patents 66
  5. Dispositions of converted wet lands and highly erodible croplands 66
  6. Prepayments 66
B. TIMBER AND ORNAMENTAL TREES 67
  1. Reforestation expenses 67
  2. Expenses of growing timber and ornamental trees 67
C. CAPITAL GAINS FOR COAL, IRON ORE, AND TIMBER 68
  1. Capital gain treatment for coal and domestic iron ore royalties 68
  2. Capital gain rules applicable to timber 68
D. HARD MINERALS 69
  1. Exploration and development costs 69
  2. Depletion of hard minerals 69
  3. Mining and solid waste reclamation costs 70
  4. Gain on disposition of interest in mining property 70
E. OIL AND GAS 71
  1. Intangible drilling costs 71
  2. Depletion for oil and gas 72
  3. Gain on disposition of interest in oil, gas, or geothermal property 72
F. ENERGY RELATED TAX CREDITS AND OTHER INCENTIVES 73
  1. Residential energy tax credits 73
  2. Business energy tax credits 73
  3. Credit for fuels from nonconventional sources 74
  4. Alcohol fuels credit and tax exemptions; import duty 74
G. GIFT AND ESTATE TAX DEDUCTIONS FOR CERTAIN CONSERVATION EASEMENT DONATIONS 75

**VIII. Excise and Employment Taxes** 76

A. EXCISE TAXES 76
  1. Increase in wine excise tax rates to beer tax equivalent rate 76
  2. Adjust alcohol, tobacco, and fuel excise tax rates to reflect increases in price 76
  3. Collection of diesel fuel tax 76
  4. Taxicab fuels tax exemption 76
  5. Windfall profit tax exemption for exchanges of crude oil 76
B. EMPLOYMENT TAXES 77
  1. Exemption from social security coverage for retired Federal judges on active duty 77
  2. FUTA tax provisions 77

**IX. Financial Institutions** 78

A. RESERVE FOR BAD DEBTS 78
  1. Commercial banks 78
  2. Thrift institutions 78

Page

B. Interest on Debt Used To Purchase or Carry Tax-Exempt Obligations ..... 79
C. Reorganizations of Financially Troubled Thrift Institutions ..... 80
  1. Qualification for tax-free status ..... 80
  2. Net operating losses ..... 80
  3. FSLIC payments ..... 80
D. Credit Unions ..... 81
E. Special Rules for Net Operating Loss Carryovers of Depository Institutions ..... 81
F. Treatment of losses on Deposits in Insolvent Financial Institutions ..... 81

X. Foreign Tax Provisions ..... 82

A. Foreign Tax Credit ..... 82
  1. Foreign tax credit limitation ..... 82
  2. Credit for taxes in lieu of income taxes ..... 83
  3. Effect of losses on foreign tax credit ..... 84
  4. Deemed-paid credit ..... 85
B. Source Rules ..... 86
  1. Income derived from purchase and sales of inventory-type property ..... 86
  2. Income from manufacture and sale of inventory-type property ..... 86
  3. Income from the sale of intangible property ..... 87
  4. Income derived from sale of other personal property ..... 87
  5. Transportation income ..... 88
  6. Other offshore income and income earned in space ..... 89
  7. Dividend and interest income ..... 89
  8. Allocation of interest and other expenses ..... 90
C. U.S. Taxation of Income Earned Through Foreign Corporations ..... 91
  1. Tax haven income subject to current tax ..... 91
  2. Application of accumulated earnings tax and personal holding company tax to foreign corporations ..... 93
D. Special Tax Provisions for U.S. Persons ..... 94
  1. Possession tax credit ..... 94
  2. Other rules with respect to U.S. possessions ..... 96
  3. Taxation of U.S. employees of Panama Canal Commission ..... 98
  4. Foreign Sales Corporations (FSCs) ..... 99
  5. Private sector earnings of Americans abroad ..... 99
  6. Transfers of intangibles to related parties outside of the U.S. ..... 99
  7. Compliance provisions applicable to U.S. persons resident abroad ..... 100
  8. Foreign investment companies ..... 100
E. Foreign Taxpayers ..... 101
  1. Branch-level tax ..... 101
  2. Retain character of effectively connected income ..... 101
  3. Tax-free exchanges by expatriates ..... 101
  4. Excise tax on insurance premiums paid to foreign insurers ..... 102
  5. Foreign investment in U.S. business assets ..... 102
  6. Withholding tax on interest paid to foreign persons ..... 103
  7. Reporting by foreign-controlled U.S. corporations ..... 103
  8. Foreign investors in U.S. partnerships ..... 104
  9. Income of foreign governments ..... 104
  10. Transfer prices for imports (sec. 482) ..... 104
  11. Dual resident companies ..... 104
  12. Interest paid to related tax-exempt parties ..... 104
F. Foreign Currency Exchange Gain or Loss ..... 105
  1. Foreign currency transactions ..... 105
  2. Foreign currency translation ..... 105
  3. Effective date ..... 106

XI. Insurance Products and Companies ..... 107

A. Insurance Products ..... 107
  1. Life insurance products ..... 107
  2. Other policyholder issues ..... 108
B. Life Insurance Companies ..... 109
  1. Reserves ..... 109
  2. Special deductions ..... 109
  3. Tax-exempt entities engaged in insurance activities ..... 110
  4. Operations loss deduction of insolvent companies ..... 111
C. Property and Casualty Insurance Companies ..... 112
  1. Reserve deductions ..... 112
  2. Policyholder dividend deduction for mutual companies ..... 113
  3. Protection against loss account for mutual companies ..... 114
  4. Special exemptions, rates, and deductions of small mutual companies ..... 114

XII. Interest Expense ..... 115

A. Nonbusiness Interest Limits ..... 115
  1. General limitation ..... 115
  2. Interest subject to limitation ..... 115
  3. Investment income defined ..... 115
  4. Net leases ..... 115
  5. Rental property ..... 116
  6. Effective date ..... 116
B. Deduction for Interest on Loans to Make IRA Contributions ..... 116

XIII. Minimum Tax ..... 117

A. Individual Minimum Tax ..... 117
  1. Structure ..... 117
  2. Rate ..... 117
  3. Exemption amount ..... 117
  4. Tax preferences ..... 117
  5. Itemized deductions ..... 120
  6. Regular tax elections ..... 120
  7. Adjustments in other years when taxpayer pays minimum tax ..... 120
  8. Incentive credits ..... 120
  9. Foreign tax credit ..... 120
  10. Net operating losses (NOLs) ..... 120
  11. Effective date ..... 120
B. Corporate Minimum Tax ..... 121
  1. Structure ..... 121
  2. Rate ..... 121

Page
3. Exemption amount 121
4. Tax preferences 121
5. Regular tax elections 123
6. Adjustments in other years when taxpayer pays minimum tax 123
7. Incentive credits 123
8. Foreign tax credit 123
9. Net operating losses (NOLs) 123
10. Estimated tax payments 123
11. Effective date 123

XIV. Pensions and Deferred Compensation; Employee Benefits; ESOPs 124

A. TREATMENT OF TAX-FAVORED SAVINGS 124
1. Individual retirement accounts (IRAs) 124
2. Qualified cash or deferred arrangements (sec. 401(k) plans) 125
3. Employer matching contributions and employee contributions 129
4. Unfunded deferred compensation arrangements of State and local governments and tax-exempt employers 131
5. Deferred annuity contracts 132
6. Elective contributions under tax-sheltered annuities 133
7. Special rules for simplified employee plans 134
B. MINIMUM STANDARDS FOR QUALIFIED PLANS 135
1. Nondiscrimination rules 135
2. Benefit forfeitures 140
3. Vesting 141
C. WITHDRAWAL OF BENEFITS 143
1. Uniform minimum distribution rules 143
2. Withdrawals before age 59½ 143
3. Uniform tax treatment of distributions 145
4. Loans under qualified plans 146
D. TAX DEFERRAL UNDER QUALIFIED PLANS 148
1. Overall limits on contributions and benefits 148
2. Deductions for contributions to qualified plans 151
3. Asset reversions under qualified plans 152
E. MISCELLANEOUS PENSION AND DEFERRED COMPENSATION PROVISIONS 153
1. Plan amendments not required until January 1, 1988 153
2. Discretionary contribution plans 153
3. Requirement that collective bargaining agreement be bona fide 154
4. Penalty for overstatement of pension liabilities 154
F. EMPLOYEE BENEFITS 155
1. Statutory employee benefit exclusions 155
2. Nondiscrimination requirements for employee benefit plans 157
3. Benefits provided under a cafeteria plan 165
4. Prizes and awards 165
5. Accrued vacation pay 166
6. Faculty housing 166
7. Parents of airline employees; airline affiliate employees 167
8. Health benefits for retirees 168

Page
G. EMPLOYEE STOCK OWNERSHIP PLANS (ESOPs) 169
1. ESOPs as employee benefit plans 169
2. Incentives for ESOP financing 173

XV. Research and Development 174

A. EXPENSING OF R&E EXPENDITURES; INCREMENTAL RESEARCH TAX CREDIT 174
1. Expensing 174
2. Incremental tax credit 174
3. Donations of scientific equipment 175
B. ALLOCATION OF RESEARCH EXPENSES TO FOREIGN SOURCE INCOME 175
C. PERSONAL HOLDING COMPANIES 176
D. UNIVERSITY BASIC RESEARCH CREDIT 176

XVI. Real Estate Provisions 177

A. AT-RISK RULES 177
B. TAX CREDIT FOR REHABILITATION EXPENDITURES 177
1. Nonhistoric structures 177
2. Certified historic structures 178
3. Transition rules 178
C. LOW-INCOME HOUSING 179
1. Five-year amortization of expenditures to rehabilitate low-income housing 179
2. Credit for low-income rental housing 180
D. REAL ESTATE INVESTMENT TRUSTS 182
1. General requirements 182
2. Asset and income requirements 183
3. Definition of rents 183
4. Distribution requirements 184
5. Capital gains 184
6. Prohibited transactions 185
7. Deficiency dividends 185
8. Effective date 185

XVII. Tax-Exempt Bonds 186

A. GENERAL RESTRICTIONS ON TAX-EXEMPTION 186
B. TAX-EXEMPT BONDS FOR CERTAIN NONGOVERNMENTAL ACTIVITIES 190
1. Industrial development bonds 190
2. Student loan bonds 194
3. Mortgage revenue bonds 195
4. Tax-exempt bonds for section 501(c)(3) organizations 196
5. Qualified redevelopment bonds 197
6. Miscellaneous restrictions on tax-exempt bonds 200
C. VOLUME LIMITATIONS ON NONGOVERNMENTAL BONDS 201
D. ARBITRAGE RESTRICTIONS 205
1. Profit limitations and determination of bond yield 205
2. Prohibition of advance refundings 208
3. Restriction on early issuance of bonds 209
E. INFORMATION REPORTING REQUIREMENT FOR ALL TAX-EXEMPT BONDS 209
F. SPECIAL TRANSITIONAL EXCEPTIONS 209
G. GENERAL STOCK OWNERSHIP CORPORATIONS (GSOCs) 209

Page

XVIII. Trusts and Estates; Generation-Skipping Transfers .......... 210

- A. INCOME OF A MINOR CHILD .......... 210
  - 1. Unearned income of a minor child .......... 210
  - 2. Personal exemption and zero bracket amount .......... 210
- B. INCOME TAXATION OF TRUSTS AND ESTATES .......... 211
  - 1. In general .......... 211
  - 2. Trusts other than grantor trusts .......... 211
  - 3. Taxation of trusts after the death of the grantor .......... 213
  - 4. Taxation of distributions to beneficiaries .......... 213
  - 5. Taxation of previously accumulated income .......... 214
  - 6. Grantor trusts .......... 214
  - 7. Estates .......... 215
- C. GENERATION-SKIPPING TRANSFER TAX .......... 216
  - 1. Taxable transfers .......... 216
  - 2. Exemption from tax .......... 216
  - 3. Tax rate .......... 216
  - 4. Credit for State taxes .......... 217
  - 5. Effective dates .......... 217

Page

XIX. Miscellaneous Provisions .......... 218

- A. EXPIRING PROVISIONS .......... 218
  - 1. Tax credit for orphan drug clinical testing .......... 218
  - 2. Expensing of costs of removing architectural barriers to the handicapped and elderly .......... 218
  - 3. Rules for spouses of Vietnam MIAs .......... 218
  - 4. Targeted jobs tax credit .......... 218
- B. OLYMPIC TRUST FUND AND EXCISE TAX .......... 219
- C. EXEMPT ORGANIZATIONS .......... 220
  - 1. Exchanges and rentals of membership lists of certain tax-exempt organizations .......... 220
  - 2. Distribution of low-cost articles by charities .......... 220
  - 3. Tax exemption for certain title-holding companies .......... 220
- D. ALLOCATION OF HOUSING COOPERATIVE INTEREST AND TAXES .......... 221
- E. FOSTER CARE PAYMENTS .......... 221

# INTRODUCTION

This document [1] provides a comparative description of tax reform proposals in connection with the markup by the Senate Committee on Finance, beginning on March 18, 1986.

The document, in columnar form for each item, includes: present law (Col. 2); the President's tax reform proposal [2] (Col. 3); the House-passed tax reform bill, H.R. 3838 [3] (Col. 4); and the Finance Committee Chairman's proposal (Col. 5).

**Note:** The phrase, "Same as House bill," does not necessarily imply the exact statutory language used in the House bill (ie., there may be technical or clerical changes to the House statutory language), but rather the same substantive policy as reflected in the House bill.

---

[1] This document may be cited as follows: Joint Committee on Taxation, *Tax Reform Proposals in Connection with Committee on Finance Markup* (JCS-8-86), March 18, 1986.

[2] The White House, *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplification*, May 1985.

[3] Passed by the House of Representatives on December 17, 1985. See also report of the Committee on Ways and Means, H. Rep. No. 99-426, December 7, 1985.

## I. INDIVIDUAL INCOME TAX PROVISIONS

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **A. Basic Rate Structure**<br>1. Tax rate schedules | The present tax structure consists of up to 15 taxable income brackets and tax rates above the zero bracket amount (ZBA). The following figures apply for 1986 and reflect an inflation adjustment for 1985. | The tax structure would consist of three taxable income brackets and tax rates—15, 25, and 35 percent—above the ZBA. Indexing would be continued as under present law. | Same as President's proposal, except for modifications shown below. | Same as President's proposal, except for modifications shown below. |
| *a. Married individuals filing jointly and surviving spouse* | (a) 14 taxable income brackets above the ZBA of $3,670; 11-percent tax rate starts above $3,670; rates rise to the maximum 50-percent rate above $175,250. | (a) *Tax rate* — *Brackets*<br>ZBA — $0 to 4,000<br>15% — $4,000 to 29,000<br>25% — $29,000 to 70,000<br>35% — Over $70,000 | (a) *Tax rate* — *Brackets*<br>ZBA — replaced by standard deduction<br>15% — $0 to $22,500<br>25% — $22,500 to $43,000<br>35% — $43,000 to $100,000<br>38% — Over $100,000 | (a) *Tax rate* — *Brackets*<br>ZBA — replaced by standard deduction<br>15% — 0 to $20,000<br>25% — $20,000 to $57,000<br>35% — Over $57,000 |
| *b. Head of household* | (b) 14 taxable income brackets above the $2,480 ZBA; 11-percent tax rate starts above $2,480; rates rise to the 50-percent rate above $116,870. | (b) *Tax rate* — *Brackets*<br>ZBA — $0 to 3,600<br>15% — $3,600 to 23,000<br>25% — $23,000 to 52,000<br>35% — Over $52,000 | (b) *Tax rate* — *Brackets*<br>ZBA — replaced by standard deduction<br>15% — $0 to $16,000<br>25% — $16,000 to $34,000<br>35% — $34,000 to $75,000<br>38% — Over $75,000 | (b) *Tax rate* — *Brackets*<br>ZBA — replaced by standard deduction<br>15% — 0 to $14,000<br>25% — $14,000 to $42,000<br>35% — Over $42,000 |
| *c. Single individuals* | (c) 15 taxable income brackets above the $2,480 ZBA; 11-percent tax rate starts above $2,480; rates rise to the 50-percent rate above $88,270.<br>(For married individuals filing separate returns, the ZBA is one-half the ZBA on joint returns, and the taxable income amounts begin at one-half the amounts for joint returns.) | (c) *Tax rate* — *Brackets*<br>ZBA — $0 to 2,900<br>15% — $2,900 to 18,000<br>25% — $18,000 to 42,000<br>35% — Over $42,000<br>*Effective date.*—The changed tax rates and taxable income brackets would become effective on July 1, 1986. For taxable year 1986, tax rate schedules would blend the present-law schedules with the new schedules. | (c) *Tax rate* — *Brackets*<br>ZBA — replaced by standard deduction<br>15% — $0 to $12,500<br>25% — $12,500 to $30,000<br>35% — $30,000 to $60,000<br>38% — Over $60,000<br>*Effective date.*—Same as President's proposal. | (c) *Tax rate* — *Brackets*<br>ZBA — replaced by standard deduction<br>15% — 0 to $11,250<br>25% — $11,250 to $35,000<br>35% — Over $35,000<br>*Effective date.*—The changed tax rates and taxable income brackets would become effective on July 1, 1987. For taxable year 1987, tax rate schedules would blend the schedules of rates that would have applied under present law (i.e., 1986 rates as adjusted for inflation) with the new schedules. |
| 2. Zero bracket amount (standard deduction)<br>*a. Increased standard deduction for all individuals* | (a) The following zero bracket amounts apply for 1986 and reflect an inflation adjustment for 1985.<br>*Filing status* — *ZBA*<br>Joint returns and surviving spouse — $3,670<br>Head of household — 2,480<br>Single individuals — 2,480<br>The ZBA is indexed annually for changes in the inflation rate. | (a) The following increased zero bracket amounts would apply for 1986.<br>*Filing status* — *ZBA*<br>Joint returns and surviving spouse — $4,000<br>Head of household — 3,600<br>Single individuals — 2,900<br>Indexing would be continued as in present law. | (a) Instead of the ZBA, individuals are allowed a standard deduction. In 1987, the standard deduction is increased to the following amounts:<br>*Filing status* — *Standard deduction*<br>Joint returns and surviving spouse — $4,800<br>Head of household — $4,200<br>Single individuals — $2,950 | (a) Instead of the ZBA, individuals would be allowed a standard deduction. In 1988, the standard deduction would be increased to the following amounts:<br>*Filing status* — *Standard deduction*<br>Joint returns and surviving spouse — $5,150<br>Head of household — $4,500<br>Single individuals — $3,200 |

## I. INDIVIDUAL INCOME TAX PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **2. Zero bracket amount (standard deduction) (Cont.)**<br>*a. Increased standard deduction for all individuals (Cont.)* | | | These increased standard deduction amounts are effective on January 1, 1987, and are indexed for inflation beginning in 1988. For 1986, the standard deduction is the same amount as the ZBA for 1986 under present law. | These increased standard deduction amounts would be effective on January 1, 1988, and would be indexed for inflation beginning in 1989. For 1987, the standard deduction would be the same amount as the ZBA that would have applied for 1987 under present law (i.e., the 1986 ZBA as adjusted for inflation in 1986). |
| *b. Additional standard deduction amount for elderly or blind individuals* | (b) No provision. | (b) No provision. | (b) An additional standard deduction amount of $600 (indexed for inflation beginning in 1988) is allowed for an elderly or blind individual. For these taxpayers only, the new standard deduction amounts listed in (a) above (otherwise effective in 1987) and the additional $600 standard deduction amount are effective on January 1, 1986. | (b) An additional standard deduction amount of $600 (indexed for inflation beginning in 1989) would be allowed for an elderly or blind individual. For these taxpayers only, the new standard deduction amounts listed in (a) above (otherwise effective in 1988) and the additional $600 standard deduction amount would be effective on January 1, 1987. |
| **3. Personal exemption** | The personal exemption for an individual, the individual's spouse, and each dependent is $1,080 for 1986 (reflecting an inflation adjustment for 1985). One additional personal exemption is provided for an individual who is age 65 or older, and for an individual who is blind. | The personal exemption for an individual, an individual's spouse, and each dependent would be increased to $2,000. Indexing would be continued as under present law. The additional exemption for elderly or blind individuals would be repealed.<br>*Effective date.*—Taxable years beginning on or after January 1, 1986. | Same as President's proposal in providing a $2,000 exemption and repealing the additional exemption for elderly or blind individuals. However, itemizers must reduce their total itemized deductions by $500 times the number of personal exemptions claimed, beginning in 1986. The $500 amount will be indexed for inflation beginning in 1987.<br>*Effective date* (personal exemption amount and floor under itemized deductions).—Taxable years beginning on or after January 1, 1986. | Same as President's proposal, except that the personal exemption would be phased out between $100,000–$200,000 of adjusted gross income.<br>*Effective date.*—Taxable years beginning on or after January 1, 1987. |

## I. INDIVIDUAL INCOME TAX PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **4. Limitation on tax-liability reduction for highest-bracket individuals attributable to personal exemptions and certain itemized deductions** | Under present law, an individual's gross income is reduced by certain adjustments in computing adjusted gross income (AGI). For taxpayers who itemize, AGI is then reduced by itemized deductions (to the extent exceeding the applicable ZBA) and by personal exemptions. For nonitemizers, AGI is reduced by the nonitemizer charitable deduction and by personal exemptions.<br>The dollar amount by which an individual's income tax liability is reduced by virtue of itemized deductions (above the ZBA), the nonitemizer charitable deduction, or personal exemptions equals the amount of such deductions and exemptions multiplied by the applicable marginal tax rate. For example, for an individual in the highest (50 percent) bracket, itemized deductions (above the ZBA) totaling $1,000 can reduce tax liability by $500; for an individual in the 30 percent bracket, the tax liability reduction cannot exceed $300. | No provision. | No provision. | Individuals in the highest (35 percent) bracket would be subject to a limitation on the extent to which their tax liability can be reduced by virtue of (1) the personal exemption and (2) itemized deductions (in excess of the standard deduction) *other than* deductions for mortgage interest on principal or second residences, real property taxes, and charitable contributions.<br>Under the limitation, these items could not reduce an individual's income tax liability by more than the amount of such exemptions or deductions multiplied by the middle tax bracket rate (25 percent). For example, if an unmarried individual in the highest bracket (35 percent) had $1,000 of such excess itemized deductions, the maximum tax liability reduction attributable to such deductions, plus one $2,000 personal exemption, would be $750 (25 percent of $3,000) rather than $1,050 (35 percent of $3,000).<br>This limitation would not apply to itemized deductions for home mortgage interest, real property taxes, and charitable contributions. Also, this limitation would not affect individuals whose taxable income, computed without deducting the itemized deductions subject to the limitation or the personal exemption, would place them in the 15-percent or 25-percent bracket. The limitation would apply to personal exemptions of any nonitemizers who are in the highest (35 percent) bracket; the limitation would not apply to the nonitemizer charitable deduction.<br>This limitation would be implemented by adding to income tax liability 10 percent of the *lower* of (a) the sum of those itemized deductions (in excess of the standard deduction) subject to the limitation plus the personal exemptions claimed on the return, or (b) the amount in (a) plus taxable income, minus the applicable dollar figure defining the beginning of the 35-percent bracket.<br>*Effective date.*—Taxable years beginning on or after January 1, 1987. |

## I. INDIVIDUAL INCOME TAX PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **5. Two-earner deduction** | Under present law, differing rate schedules and zero bracket amounts contribute to an increased tax liability (marriage penalty) when two single taxpayers marry and file a joint return. Couples filing a joint return are allowed a tax deduction equal to 10 percent of the lesser of the earned income of the lower-earning spouse or $30,000; the maximum deduction thus is $3,000. | The two-earner deduction would be repealed.<br>*Effective date.*—Taxable years beginning on or after January 1, 1986. | Same as President's proposal (marriage penalty relief provided through standard deduction and rate schedules).<br>*Effective date.*—Same as President's proposal. | Same as House bill.<br>*Effective date.*—Taxable years beginning on or after January 1, 1987. |
| **6. Earned income credit** | Taxpayers with one or more children are allowed a credit of 11 percent of their first $5,000 of earned income (maximum credit of $550). The amount of the credit is reduced as income rises over $6,500, and the credit is totally phased-out at $11,000 of AGI. The credit is refundable. | The allowable credit would be increased to 14 percent of the first $5,000 of earned income (maximum credit of $700). The income level at which the phaseout begins would be raised to $6,500 with a total phaseout at $13,500 of AGI. The maximum amount of the credit as well as the phaseout income levels would be adjusted for inflation occurring after 1984.<br>*Effective date.*—Taxable years beginning on or after January 1, 1986. | Same as President's proposal, except that, for taxable years beginning on or after January 1, 1987, the income level at which the phaseout begins is increased to $9,000. Because the rate of phaseout is the same as President's proposal, total phaseout does not occur until $16,000 of AGI. | Effective for taxable years beginning in 1987, the earned income credit would be increased to 14 percent of the first $5,000 of earned income (maximum credit of $700), and the income phase-out levels would be increased to $6,500/$13,500, with these amounts being adjusted for inflation in 1985-86. Effective for taxable years beginning on or after January 1, 1988, the income phase-out levels would be increased to $9,000/$16,000, with these amounts being adjusted for inflation in 1985–87. |
| **7. Income averaging** | An eligible individual (i.e., one who has been self-supporting and a U.S. citizen or resident during the past three years) can elect to have a lower marginal rate apply to the portion of income that is more than 40 percent higher than his or her income for the prior three years. | Income averaging would be repealed.<br>*Effective date.*—Taxable years beginning on or after January 1, 1986. | Same as President's proposal. | Same as President's proposal.<br>*Effective date.*—Taxable years beginning on or after January 1, 1987. |

## I. INDIVIDUAL INCOME TAX PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **B. Tax Treatment of the Elderly and Disabled**<br>**1. Exemption for the elderly** | Present law provides an additional personal exemption ($1,080 for 1986) for an individual who is age 65 or older, or who is blind. An individual who is both age 65 or over and blind is entitled to claim two additional personal exemptions. | The additional personal exemption for an individual age 65 or over, and the additional personal exemption for an individual who is blind, would be repealed.<br>*Effective date.*—Taxable years beginning on or after January 1, 1986. | Same as President's proposal (but the standard deduction is increased by $600 for an individual over age 65, by $600 for a blind individual, and by $1,200 in the case of an individual who is both elderly and blind).<br>*Effective date.*—Taxable years beginning on or after January 1, 1986. | Same as House bill.<br>*Effective date.*—Taxable years beginning on or after January 1, 1987. |
| **2. Credit for the elderly** | Present law provides a nonrefundable income tax credit for individuals who are age 65 or over, or who have retired on permanent and total disability. The credit equals 15 percent of an initial base amount reduced by the amount of certain tax-free income received by the taxpayer and by one-half of the taxpayer's AGI exceeding a specified threshold.<br>The initial base amount is $5,000 for an unmarried individual or for a married couple filing a joint return if only one spouse is eligible for the credit; $7,500 for a married couple filing a joint return with both spouses eligible for the credit; or $3,750 for a married couple filing separate returns. For a disabled individual who is under age 65, however, the initial base amount equals the individual's disability income for the year, if less than the initial base amount.<br>The initial base amount is reduced by certain nontaxable income of the taxpayer, including pension and annuity income, social security, railroad retirement, or veterans' nonservice-related disability benefits. In addition, the initial base amount is reduced by one-half of the taxpayer's AGI in excess of $7,500, in the case of a single individual; $10,000, in case of married taxpayers filing a joint return; or $5,000, in the case of married taxpayers filing separate returns. | The tax credit for the elderly and disabled would be expanded and modified as follows:<br>(1) The class of taxpayers eligible for the credit would be expanded to include taxpayers under age 65 who (a) are blind, or (b) receive workers' compensation or black lung disability benefits.<br>(2) The initial base amount on which the credit is calculated would be increased to $7,000, in the case of an eligible single individual or a married couple filing a joint return with only one spouse eligible for the expanded credit; $9,250, in the case of a head of household; and $11,500, in the case of a married couple filing joint return where both spouses are eligible for the credit ($5,750, in the case of such a married couple filing separate returns). In addition, the initial base amount for an individual who is both elderly and blind would be increased by $1,500.<br>(3) The AGI level at which the initial base amount begins to be reduced would be increased to $11,000, in the case of an unmarried individual; $12,500, in the case of a head of household; and $14,000, in the case of a married couple filing a joint return ($7,000, in the case of a married couple filing separate returns). | Retain present law. | Retain present law. |

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **2. Credit for the elderly (Cont.)** | | (4) All dollar amounts used in determining the amount of the credit would be indexed for inflation in future years.<br>(5) For those taxpayers with workers' compensation and black lung disability benefits, the initial base amount would be the sum of (a) the amount of such benefits received, and (b) any initial base amount for which they would otherwise qualify. Under the proposal, other disability income eligible for the credit would be restricted to disability payments from a "qualified plan."<br>*Effective date.*—Taxable years beginning after December 31, 1985. | | |
| **3. Wage replacement benefits** | | | | |
| ***a. Unemployment compensation*** | Present law provides a limited exclusion from gross income for unemployment compensation benefits received under a Federal or State program. If the sum of the taxpayer's unemployment compensation benefits and AGI does not exceed a base amount, then the entire benefit amount is excluded from income. The base amount is $12,000, in the case of an unmarried individual; $18,000, in the case of a married couple filing a joint return; and zero, in the case of a married couple filing separate returns.<br>If the base amount is exceeded, then the amount of unemployment compensation benefits that is includible in income is equal to the lesser of (1) one-half of the excess of the taxpayer's combined income (modified AGI plus benefits) over the base amount, or (2) the amount of the unemployment compensation. | All unemployment compensation benefits would be includible in gross income.<br>*Effective date.*—Taxable years beginning after December 31, 1986. | Same as President's proposal. | Same as President's proposal. |

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| *b. Workers' compensation and black lung disability benefits* | Present law provides that gross income does not include amounts received under workers' compensation statutes as compensation for personal injuries or sickness. This exclusion also applies to benefits paid under a workers' compensation statute to a survivor of a deceased employee.<br>Under present law, black lung disability benefits paid for claims by coal miners are excludable from gross income as workers' compensation benefits. | All cash payments for workers' compensation and black lung disability benefits would be includible in gross income, except for payments for medical services (unless previously deducted), payments for physical and vocational rehabilitation, and payments for burial expenses.<br>Worker's compensation and black lung disability benefits would be eligible for the expanded credit for the elderly.<br>*Effective date.*—The repeal of the exclusion for workers' compensation benefits would apply to benefits attributable to disabilities occurring on or after January 1, 1987. The provision that would make workers' compensation and black lung disability benefits eligible for the expanded credit for the elderly would be effective for taxable years beginning after December 31, 1986. | Retain present law. | Retain present law. |

## I. INDIVIDUAL INCOME TAX PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **C. Scholarships and Fellowships** | *(1) In general.*—Degree candidates at an educational institution may exclude amounts received as a scholarship or fellowship grant, and also incidental amounts for expenses for travel, research, clerical help, and equipment. Nondegree candidates may exclude only scholarships or fellowship grants from tax-exempt organizations or international or governmental agencies, limited to a maximum lifetime exclusion of $10,800. The exclusion for incidental amounts received by nondegree candidates is not limited. | *(1) In general.*—Amounts received as scholarships or fellowship grants by degree candidates would be includible in the recipient's gross income except to the extent that they were required to be, and were, spent on tuition and equipment required for courses of instruction. Nondegree candidates would not be permitted to exclude any such amounts, but could exclude reimbursements for incidental expenses (travel, research, clerical help, or equipment). Degree candidates would not be permitted to exclude incidental expenses. | *(1) In general.*—Same as President's proposal, except that amounts received by nondegree candidates for incidental expenses are not excludable (although offsetting deductions are available if such costs qualify as business expenses under sec. 162). | *(1) In general.*—Same as House bill. |
| | *(2) Payments for services.*—Amounts received by degree candidates are not eligible for the exclusion if they represent payment for teaching or other services required as a condition of receiving the grant, unless all candidates for a particular degree must perform such services. | *(2) Payments for services.*—The special rule concerning performance of services required of all candidates for a particular degree would be repealed. | *(2) Payments for services.*—Same as President's proposal. | *(2) Payments for services.*—Same as President's proposal. |
| | Grants received under a Federal program which would otherwise be eligible for the exclusion, but for the fact that the recipient must perform future services as a Federal employee, are excludable to the extent used for tuition and required fees, books, supplies, and equipment. | The special rule relating to certain Federal grants would be repealed. | Same as President's proposal. | Same as President's proposal. |
| | | *Effective date.*—The proposal would be effective for scholarships and fellowships received in taxable years beginning on or after January 1, 1986, except that if a binding commitment to grant a scholarship for a degree candidate is made before January 1, 1986, amounts received would be excludable under present law through 1990. | *Effective date.*—The provision is effective for scholarships and fellowships granted after September 25, 1985. | *Effective date.*—Effective on January 1, 1987, for scholarships and fellowships granted after March 1, 1986. |

## I. INDIVIDUAL INCOME TAX PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **D. Deductions for Personal Expenditures** | | | | |
| **1. Itemized deductions for certain State and local taxes** | Individuals may claim itemized deductions with respect to the following State and local taxes: income taxes, real property taxes, personal property taxes, and sales taxes. No other State and local taxes are deductible by individuals unless incurred in a business or in an income-producing (investment) activity. | Itemized deductions for State and local taxes would be repealed.<br>State and local taxes other than income taxes would be deductible if incurred in a business or, subject to the limitation in the following sentence, in an investment activity. When incurred by an individual in an investment activity, these taxes would be among the category of expenditures that would be deductible "above-the-line" to the extent exceeding one percent of adjusted gross income (see item E.2, below).<br>*Effective date.*—Taxable years beginning after 1985. | Same as present law. | Itemized deductions for State and local sales taxes and personal property taxes not incurred in a business or investment activity would be repealed. (If incurred in a business or investment activity, these taxes would be capitalized, if appropriate, or deductible under the general rules allowing deductions for such activities.) Itemized deductions for real property taxes would be allowed as under present law. Itemized deductions for income taxes would be allowed as under present law, subject to the limitation (see I.A.4, above) applicable to taxpayers in the 35-percent bracket.<br>*Effective date.*—Taxable years beginning on or after January 1, 1987. |
| **2. Charitable deduction for nonitemizers** | Nonitemizers may deduct their charitable contributions in addition to taking the standard deduction (ZBA), subject to limitations for pre-1986 years.<br>The maximum nonitemizer deduction was $25 for 1982 and 1983, and $75 for 1984. For 1985, 50 percent of the amount contributed was deductible, without a dollar cap. For 1986, the full amount of contributions is deductible.<br>Under present law, no deduction (beyond the standard deduction) is provided for charitable contributions by nonitemizers made after 1986. | The nonitemizer charitable deduction would be repealed for contributions made after 1985, i.e., one year earlier than the scheduled termination of the nonitemizer deduction under present law. | The bill makes permanent the nonitemizer charitable deduction. The bill modifies the deduction by providing that, for taxable years beginning after 1985, the deduction is subject to a $100 floor. | The nonitemizer charitable deduction would be made permanent (with no floor).<br>*Effective date.*—On enactment. |
| **3. Adoption expenses** | An itemized deduction is allowed for up to $1,500 of adoption fees and expenses (such as court costs and attorneys' fees) for the adoption of a child with special needs, i.e., handicapped or other children eligible for adoption assistance payments under the Social Security Act. | The itemized adoption expense deduction would be repealed in anticipation that a direct expenditure program would be enacted to continue Federal support for families adopting children with special needs.<br>*Effective date.*—Generally January 1, 1987, except that present law would apply for pre-1986 adoptions and special phaseout rules would apply for adoptions during 1986. | Same as President's proposal:<br>(a) the adoption expense deduction is repealed; and<br>(b) the Adoption Assistance program in Title IV-E of the Social Security Act is amended to provide matching funds as an administrative expense for adoption expenses for any child with special needs who has been placed for adoption in accordance with applicable State and local law. Such expenses include all qualified adoption expenses included in the current tax deduction provision. The effective date is to be coordinated with repeal of the current tax deduction. | Retain present law. |

## I. INDIVIDUAL INCOME TAX PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| 4. Deductibility of mortgage interest and taxes allocable to tax-free allowances for ministers and military personnel | The IRS has ruled that a minister may not deduct mortgage interest and property taxes allocable to a tax-free parsonage allowance. This ruling was based on Code section 265(1), which disallows deductions for expenses allocable to tax-exempt income. This ruling applied effective July 1, 1983, subject to transitional relief (extended through 1986) for ministers owning homes before 1983. | No provision. | The bill provides a permanent rule (effective retroactively) that ministers receiving tax-free parsonage allowances, as well as military personnel receiving tax-free military housing allowances, are not precluded by section 265 from deducting mortgage interest or real property taxes on the taxpayer's residence. | Same as House bill. |

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **E. Expenses for Business or Investment** | | | | |
| **1. Travel and entertainment expenses** | | | | |
| ***a. Meal expenses*** | (a) Meal expenses that constitute ordinary and necessary business expenses generally are deductible if the meal takes place in an atmosphere conducive to business discussion, whether or not business is discussed before, during, or after the meal. Unlike the substantiation rules for deducting other entertainment expenses (see below), the taxpayer need not show that such meal expenses are either directly related to or associated with the active conduct of business. | (a) Allowable deductions for a business meal would be limited to $25 times the number of participants in the meal, plus one-half of the excess. This limit would apply to a taxpayer's meals while away from home on business, but not to meals furnished on the premises of the taxpayer primarily for its employees. | (a) Under the House bill, 80 percent of otherwise allowable business meal expenses (including meals away from home) can be deducted. This reduction rule also applies to meals furnished on an employer's premises to its employees, unless (i) taxed as compensation, or (ii) excludable under the subsidized eating facility or de minimis fringe benefit exclusions (sec. 132). Certain other exceptions apply.<br>In addition, no deduction is allowed unless (i) business is discussed during, or directly before or after, the meal (except for an individual eating alone while away from home on business), and (ii) the meal has a clear business purpose, presently related to the active conduct of the taxpayer's business. The Treasury is instructed to tighten substantiation requirements; special fraud and negligence penalties apply to certain improper deductions. | (a) Same as House bill. |
| ***b. Entertainment expenses other than for meals*** | (b) Entertainment expenses are deductible if, in addition to constituting ordinary and necessary business expenses, they are either (i) directly related to the active conduct of the taxpayer's business, or (ii) if directly preceding or following a substantial and bona fide business discussion, associated with the active conduct of the taxpayer's business.<br>No deduction or credit is allowed for the cost of purchasing or constructing certain entertainment facilities (e.g., luxury skyboxes). This limitation does not apply to the rental of such a facility. | (b) Deductions for entertainment expenses would be denied, with the following limited exceptions: (i) expenses paid under a reimbursement arrangement (in which case the deduction would be denied to the party making the reimbursement), (ii) items taxed as compensation to the beneficiaries, (iii) recreational expenses for employees (e.g., Christmas parties), and (iv) items made available to the general public (e.g., samples and promotional activities). | (b) 80 percent of otherwise allowable entertainment expenses can be deducted. Items listed as exceptions under the President's proposal are deductible in full (with reduction rule applicable to a taxpayer that reimburses entertainment expenses), as well as the full amount paid for tickets to certain charitable fundraising sports event. Ticket costs in excess of face value are nondeductible, except with regard to tickets for charitable fundraising sports events.<br>In addition, deductions for the rental or other use of a luxury skybox at a sports arena are disallowed, to the extent in excess of the cost of regular tickets, if used by the taxpayer for more than one event. | (b) Same as House bill, except without the special rule in the House bill for skyboxes. |

## I. INDIVIDUAL INCOME TAX PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| ***c. Travel expenses (other than conventions)*** | *(c)(1) Luxury water transportation.*—Travel expenses incurred by the taxpayer while away from home in the conduct of a business generally are deductible. However, the cost of commuting to and from work is not deductible. | *(c)(1) Luxury water transportation.*—No deduction would be allowed for the cost of luxury water transportation, to the extent in excess of the cost of otherwise available business transportation. | *(c)(1) Luxury water transportation.*—Deductions for luxury water transportation are limited (subject to certain exceptions) to twice the highest Federal travel per diem times the number of days in transit. This limitation does not apply to deductions for cruise ship conventions, which remain subject to present-law limitations. | *(c)(1) Luxury water transportation.* Same as House bill. |
|  | *(2) Educational travel.*—Travel may qualify as a form of education, and thus may give rise to a deduction, on the ground that traveling itself maintains or improves existing employment skills or is required by an employer or by applicable laws or regulations. | *(2) Educational travel.*—No deduction would be allowed for travel that would be deductible only on the ground that the travel constitutes a form of education. | *(2) Educational travel.*—Same as President's proposal. | *(2) Educational travel.*—Same as President's proposal. |
|  | *(3) Charitable travel.*—Travel away from home may give rise to a charitable deduction when—<br>(i) an individual deducts out-of-pocket travel expenses on the ground that they were incurred in performing services for the charity; or<br>(ii) the charity itself pays for travel by an individual who has made a contribution to the charity. | *(3) Charitable travel.*—No provision. | *(3) Charitable travel.*—The present-law rule applicable to medical deductions for lodging costs away from home (sec. 213(d)(2)(B)) is extended to charitable deductions claimed for transportation and other travel expenses incurred in performing services away from home for a charitable organization. Thus, no deduction is allowed for such expenses (whether paid directly by the individual or indirectly through a contribution to the organization) unless "there is no significant element of personal pleasure, recreation, or vacation in the travel away from home." | *(3) Charitable travel.*—Retain present law. |

## I. INDIVIDUAL INCOME TAX PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| *c. Travel expenses (other than conventions) (Cont.)* | *(4) Away from home limitation.*—There is no statutory time limit on the period during which a taxpayer may qualify as "away from home," thus giving rise to deductions for transportation expenses and meals, lodging, and other living expenses. For example, an individual who maintains a primary residence or principal place of business in one city may, under some circumstances, deduct the costs of living in another city, even for a period in excess of one year, in connection with temporary employment in that city. | *(4) Away from home limitation.*—For purposes of determining whether an individual is away from home, work assignments that extend for more than one year in a location would be considered indefinite rather than temporary, and no deductions would be allowed for travel to and from the job site and the individual's residence or for meals and living expenses at the job site. | *(4) Away from home limitation.*—Retain present law. | *(4) Away from home limitation.*—Retain present law. |
| *d. Travel expenses for attending conventions* | *(d)(1) In general.*—The cost of attending a convention or seminar, either for business or for investment purposes, generally is deductible. | *(d)(1) In general.*—No special rule (see meal and entertainment limitations described above). | *(d)(1) In general.*—The cost of attending a convention or seminar for investment purposes is not deductible. | *(d)(1) In general.*—Same as House bill. |
|  | *(2) Foreign conventions.*—No deduction is allowed for the cost of attending a convention outside of the North American area (i.e., not in the U.S., Canada, Mexico, or certain Caribbean countries) unless the taxpayer can show that it was as reasonable to hold the convention there as in the North American areas. Certain Caribbean countries, including Bermuda, are treated as in the North American area if they make available certain tax information to U.S. authorities. | *(2) Foreign conventions.*—No special provision. Under S. 1718 (introduced at the request of the Administration), Bermuda would qualify as in the North American area even if it does not make available tax information, subject to Presidential certification. | *(2) Foreign conventions.*—No special provision. | *(2) Foreign conventions.*—Same as S. 1718 (see President's proposal). |
|  | *(3) Cruise-ship conventions.*—Deductions for attending conventions held on cruise ships are limited to $2,000 per taxpayer per year, and are wholly disallowed unless the cruise ship is registered in the U.S. and stops at ports of call only in the U.S. In addition, special substantiation rules apply. | *(3) Cruise-ship conventions.*—No deduction would be allowed for the cost of attending conventions, seminars, or other meetings held aboard cruise ships. | *(3) Cruise-ship conventions.*—Retain present law. | *(3) Cruise-ship conventions.*—Retain present law. |
| *e. Effective date (all travel and entertainment provisions)* |  | (e) Taxable years beginning after December 31, 1985. | (e) Same as President's proposal. | (e) Taxable years beginning after December 31, 1986. |

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **2. Employee business expenses, investment expenses, and other miscellaneous itemized deductions** | | | | |
| ***a. Miscellaneous itemized deductions*** | (a) A number of expenses of producing income are allowable only as itemized deductions. This category, commonly called the "miscellaneous deductions," consists principally of certain employee business expenses, certain expenses of earning investment income, and expenses relating to filing tax returns. | (a) The miscellaneous itemized deductions would be moved "above-the-line" (i.e., would also be deductible by nonitemizers), and allowed only to the extent that, when aggregated with the employee expenses described below, they exceeded one percent of the taxpayer's adjusted gross income (AGI). | (a) Under the House bill, a one-percent floor is placed under itemized deductions for miscellaneous employee, investment, and certain other expenses, and nonreimbursed employee travel and other expenses that presently are deductible "above-the-line" are included in the miscellaneous itemized deduction. | (a) Same as House bill. |
| ***b. "Above-the-line" expenses*** | (b) Four types of employee business expenses are allowed "above-the-line" in calculating adjusted gross income, and thus are *not* among the miscellaneous itemized deductions: (1) expenses reimbursed by the employer, (2) employee travel expenses, (3) employee transportation expenses, and (4) business expenses of employees who are outside salespersons. | (b) Employee expenses (other than those reimbursed by the employer) would be aggregated with the present miscellaneous deductions for purposes of the one-percent floor. In addition, State and local taxes (other than income taxes) that related to an investment activity of the taxpayer (other than one involving the production of rental or royalty income) would be aggregated with the miscellaneous deductions for purposes of the floor. | (b) Employee expenses (other than those reimbursed by the employer) are aggregated with the present miscellaneous itemized deductions for purposes of the one-percent floor. | (b) Same as House bill. |
| ***c. Home office expenses*** | (c) An itemized deduction is allowed for use of a part of one's home as an office subject to the following restrictions: (1) use of the home office must be for the convenience of the employer, (2) the home office must be used regularly and exclusively either as the taxpayer's principal place of business, or to meet patients, clients, or customers, and (3) the deduction cannot exceed the taxpayer's gross income from the business. A recent case held that these limits do not apply when the taxpayer leases a portion of his home to his employer. | (c) No provision. | (c) The present-law limits are to apply when an employee leases a portion of his home to his employer. In addition, the home office deduction is limited to the taxpayer's net income from the business (i.e., gross income minus deductions attributable to the business). Disallowed home office deductions may be carried forward to later years. | (c) Same as House bill. |

## I. INDIVIDUAL INCOME TAX PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| 2. Employee business expenses, investment expenses, and other miscellaneous deductions (Cont.) | | | | |
| ***d. Hobby losses*** | (d) Hobby losses are restricted to the amount of hobby income. An activity is presumed not to be a hobby if it is profitable in 2 out of 5 consecutive years, or 2 out of 7 years for horse breeding or racing. (However, an activity need not meet this standard in order to avoid treatment as a hobby.) | (d) No provision. | (d) Under the House bill, an activity (other than horse breeding or racing) is presumed not to be a hobby if it is profitable in 3 out of 5 consecutive years; present-law rules are retained for horse activities. | (d) Same as House bill. |
| ***e. Effective date*** | | (e) *Effective date* (employee business expenses, etc.).—Taxable years beginning after 1985. | *(e) Effective date* (employee business expenses, etc.).—Same as President's proposal. | (e) *Effective date* (employee business expenses, etc.).—Taxable years beginning on or after January 1, 1987. |
| **F. Political Contributions Tax Credit** | Individual taxpayers may claim a nonrefundable income tax credit equal to one-half the amount of their contributions to political candidates and certain political campaign organizations during the taxable year. The maximum allowable credit is $50 for an individual and $100 for a married couple filing a joint return. | The political contributions credit would be repealed.<br>*Effective date.*—Taxable years beginning on or after January 1, 1986. | Under the bill, a credit is allowed to individuals for the full amount of political contributions, up to a maximum of $100 ($200 for a joint return), made to a Congressional candidate for election in the State in which the taxpayer resides.<br>*Effective date.*—Taxable years beginning after 1985. | Retain present law. |
| **G. Presidential Campaign Checkoff** | Individual taxpayers may allocate $1 ($2 on a joint return) of their Federal income tax liability to the Presidential Election Campaign Fund. Monies in this fund are used to finance the campaigns of presidential and vice-presidential candidates and the nominating conventions of some political parties. | The checkoff for the Presidential Election Campaign Fund would be repealed.<br>*Effective date.*—Returns filed for 1986 (which, in general, must be filed by April 15, 1987). | Retain present law. | Retain present law. |

## II. ACCELERATED COST RECOVERY SYSTEM AND INVESTMENT TAX CREDIT

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **A. Depreciation**<br>**1. Accelerated depreciation** | | | | |
| ***a. Cost recovery classes*** | (a) *Cost recovery classes*<br>Under the Accelerated Cost Recovery System ("ACRS"), recovery deductions are determined by applying a statutory percentage to an asset's original cost (adjusted for allowable investment tax credit). The classification of assets under ACRS generally is based on the Asset Depreciation Range ("ADR") system of prior law. Under the ADR system, a present class life ("midpoint") was provided for all assets used in the same activity, other than certain assets with common characteristics (e.g., cars): | (a) *Cost recovery classes*<br>ACRS would be replaced by the Capital Cost Recovery System ("CCRS"). Under CCRS, a recovery percentage would be applied to an asset's inflation-adjusted basis. Asset classifications under CCRS would not be based on ACRS or ADR; rather assets would be identified by descriptions drawn from the U.S. National Income and Products Account prepared by the Commerce Department: | (a) *Cost recovery classes*<br>ACRS is replaced by the Incentive Depreciation System ("IDS"). Under IDS, assets would be grouped according to present class lives (or ADR midpoint lives). IDS deductions are subject to increases for inflation adjustments, beginning in 1988. | (a) *Cost recovery classes*<br>ACRS would be retained with changes in the classification of certain long-lived assets. ACRS deductions, except for real property, would be adjusted for inflation beginning on the effective date. (See II.A.3. below.) |
| | *3-year class:* Property with an ADR midpoint of 4 years or less (such as cars and light-duty trucks), *plus* property used in connection with research & experimentation and certain horses. Method is 150 percent declining balance, switching to straight line, over 3 years. | *CCRS Class 1:* 3-year ACRS property. Method is equivalent to 220 percent declining balance method, switching to straight line, over 4 years. | *Class 1:* Property with ADR midpoints under 5 years, *except* cars and light general purpose trucks, *plus* clothing held for rental. Includes motor vehicle special tools and truck tractors. Method is 200 percent declining balance, switching to straight line, over 3 years. | *3-year class:* Same as present law, *adding* computers and computer-based telephone central office switching equipment, and *excluding* cars, light trucks, and truck tractors. Method is 150 percent declining balance, switching to straight line, over 3 years. |
| | *5-year class:* All tangible personal property not included in any other class. Includes railroad track, commercial passenger aircraft, and single-purpose agricultural structures. Method is 150 percent declining balance, switching to straight line, over 5 years. | *CCRS Class 2:* Trucks, buses, trailers, and office, computing, and accounting equipment. Method is equivalent to 220 percent declining balance method, switching to straight line, over 5 years. | *Class 2:* Property with ADR midpoints of at least 3 but less than 7 years, *plus* cars and light general purpose trucks, qualified technological equipment, computer-based telephone central office switching equipment, and race horses. Includes trailers, computers, heavy trucks, electronics manufacturing, and oil and gas drilling assets. Method is 200 percent declining balance, switching to straight line, over 5 years. | *5-year class:* Same as present law, *adding* cars, light trucks, and truck tractors, and *excluding* property with ADR midpoint lives of 16 years and greater. Method is 150 percent declining balance, switching to straight line, over 5 years. |
| | *10-year class:* Public utility property with an ADR midpoint of 18.5 to 25 years, certain burners and boilers with an ADR midpoint of 25 years, and mobile homes. Method is 150 percent declining balance, switching to straight line, over 10 years. | *CCRS Class 3:* Construction machinery, tractors, aircraft, mining & oil field machinery, and instruments. Method is equivalent to 198 percent declining balance method, switching to straight line, over 6 years. | *Class 3:* Property with ADR midpoints of at least 7 but less than 10 years. Includes offshore drilling, chemicals manufacturing, and distributive trades and services assets. Method is 200 percent declining balance, switching to straight line, over 7 years. | *10-year class:* Same as present law, *adding* property that is excluded from the 5-year class because of an ADR midpoint life of 16 years and greater, and *excluding* property now classified as 15-year property. Method is 150 percent declining balance, switching to straight line, over 10 years. |
| | *15-year public utility class:* Other public utility property with an ADR midpoint of more than 25 years. Method is 150 percent declining balance, switching to straight line, over 15 years. | *CCRS Class 4:* All tangible personal property not included in any other class. Includes railroad track and furniture and fixtures. Method is 154 percent declining balance method, switching to straight line, over 7 years. | *Class 4:* Property with ADR midpoints of at least 10 but less than 13 years, *plus* horses other than race horses, and property that has no ADR midpoint and is not classified otherwise. Includes commercial passenger aircraft, mobile homes and offices, railroad track, agriculture, mining, aerospace manufacturing, and motor vehicle manufacturing. Method is 200 percent declining balance, switching to straight line, over 10 years. | *15-year class:* Property with an ADR midpoint of 20 years and greater if it is utility property or steam and electric generation or distribution systems. Method is 150 percent declining balance, switching to straight line, over 15 years. |

## II. ACCELERATED COST RECOVERY SYSTEM AND INVESTMENT TAX CREDIT—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **1. Accelerated depreciation (cont.)**<br>***(a) Cost recovery classes (cont.)*** | *15-year real property class:* Low-income housing. Method is 200 percent declining balance, switching to straight line, over 15 years. | *CCRS Class 5:* Railroad structures, ships & boats, engines & turbines, plant & equipment for generation, transmission, and distribution of electricity and other power, and distribution plant for communication services. Method is equivalent to 170 percent declining balance method, switching to straight line, over ten years. | *Class 5:* Property with ADR midpoints of at least 13 but less than 16 years, plus single-purpose agricultural or horticultural structures. Includes assets used in pulp manufacturing, primary steel manufacturing, and railroad machinery and equipment. Method is 200 percent declining balance, switching to straight line, over 13 years. | *30-year real property class:* Present law 15-year and 19-year real property. Method is straight line over 30 years. |
| | *19-year real property class:* Buildings and structures. With relatively few exceptions, ADR lives were not assigned to buildings. Method is 175 percent declining balance, switching to straight line, over 19 years. | *CCRS Class 6:* ACRS 19-year real property and low-income housing. Method is equivalent to 112 percent declining balance method, switching to straight line, over 28 years. | *Class 6:* Property with ADR midpoints of at least 16 but less than 20 years. Includes vessels and barges. Method is 200 percent declining balance, switching to straight line, over 16 years. | |
| | | | *Class 7:* Property with ADR midpoints of at least 20 but less than 25 years, *plus* very low-income housing. Includes cement manufacturing, pipeline transportation, and nuclear production of electricity. Method is 200 percent declining balance, switching to straight line, over 20 years. | |
| | | | *Class 8:* Property with ADR midpoints of at least 25 but less than 30 years, *plus* telephone distribution plant and comparable equipment used by other transmitters of information. Includes steam power production of electricity. Method is 200 percent declining balance, switching to straight line, over 25 years. | |
| | | | *Class 9:* Property with ADR midpoints of at least 30 but less than 36 years, *plus* low-income housing (other than very low-income housing). Includes railroad structures, electric transmission and distribution plant, and gas distribution facilities. Method is 200 percent declining balance, switching to straight line, over 30 years. | |
| | | | *Class 10:* Property with ADR midpoints of at least 36 years, *plus* all other real property. Method is straight line over 30 years. | |

## II. ACCELERATED COST RECOVERY SYSTEM AND INVESTMENT TAX CREDIT—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| *1. Accelerated depreciation (cont.)* | | | | |
| *b. Luxury cars* | (b) Recovery deductions for automobiles are subject to the following dollar limitations: $3,200 for the first recovery year; 4,800 for each succeeding taxable year in the recovery period. | (b) Retain present law. | (b) Same as President's proposal. | (b) Conform fixed limitations so that the price range of affected cars is unchanged. Clarify that the fixed limitations apply to all deductions claimed for depreciation of automobiles, not just recovery deductions. |
| *c. Changes in classification* | (c) Under ACRS, recovery periods are fixed. | (c) Treasury would monitor and analyze actual experience with all tangible depreciable assets so that changes could be made. made. | (c) Same as President's proposal. | (c) Same as President's proposal. |
| *d. Definition of low-income housing* | (d) Low-income housing generally is defined in relation to HUD programs. One rule defines low-income housing as a project where 85% of tenants are eligible for, but do not necessarily receive, Section 8 subsidies. Presently Section 8 eligibility is defined as families whose income is 50% or less of area median income, adjusted for family size. | (d) No provision. | (d) Low-income housing is defined as a project where either 20% of tenants have incomes equal to 70% or less of median gross income, or 25% of tenants have incomes equal to 80% or less of median gross income. Very low-income housing is defined as a project where 40% of tenants have income equal to 60% or less of median gross income. | (d) No provision (but see XVI.C.2., below). |
| 2. Alternative cost recovery system | | | | |
| *a. In general* | (a) ACRS deductions are reduced for property that is (1) used predominantly outside the United States, (2) leased to a tax-exempt entity, or (3) financed with industrial development bonds the interest on which is exempt from tax. Different depreciation methods are also used for purposes of (1) computing earnings and profits of a domestic corporation, and (2) applying the minimum tax provisions. Taxpayers can elect to use the straight-line method over the applicable ACRS recovery period (or over a longer recovery period) with respect to one or more classes of ACRS property placed in service during a taxpable year. | (a) A system intended to allow depreciation deductions that approximate the assumed decline in an asset's value would apply. Although no specific system is recommended the Administration proposal indicates that the depreciation system set forth in the 1984 Treasury report ("RCRS") would serve as the model. Under RCRS, the inflation-adjusted basis of property would be recovered over periods ranging from 5 years for short-lived property to 63 years for real property. | (a) Depreciation deductions would be computed under the method that is used under present law for property that is leased to a tax-exempt entity, which is generally straight-line over the ADR midpoint life. This method could be elected by a taxpayer for property otherwise eligible for incentive depreciation, on a class-by-class, year-by-year basis. Tax-exempt bond financed property, other than low-income housing, is depreciated using the straight-line method over the next longest IDS class (40 years for real property). | (a) Same as House bill, except all tax-exempt bond financed property would be depreciated under the method for property that is leased to a tax-exempt entity. Taxpayers would be permitted to elect to recover costs using the straight-line method over the ACRS recovery period, in lieu of ACRS. |
| *b. Property predominantly of foreign origin* | (b) There is Presidential authority to deny the investment tax credit, but not accelerated depreciation. | (b) No provision. | (b) Provide Presidential authority to deny accelerated depreciation to property produced abroad, similar to present-law rules applicable to the investment tax credit. | (b) Same as House bill. |
| *c. Property used in outer space* | (c) No provision. | (c) No provision. | (c) Property launched by a U.S. person from the United States and used in outer space would not be treated as foreign use property. | (c) Same as House bill. |

## II. ACCELERATED COST RECOVERY SYSTEM AND INVESTMENT TAX CREDIT—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| 3. Indexing | The basis of depreciable property is not adjusted for inflation; however, depreciation allowances are accelerated, in part, to compensate for inflation. | Beginning with the second year an asset is in service, the asset's unrecovered basis would be adjusted upwards for inflation. | Beginning in 1988, IDS deductions are eligible for increases for inflation. Generally, the deductions would be increased for half the annual inflation in excess of 5 percent since the second year an asset is placed in service. | For property other than 30-year real property, ACRS deductions would be eligible for increases for inflation. Generally, the deductions would be increased for the full amount of inflation in excess of a 2 percent annual average since the second year an asset is placed in service. The inflation adjustment would be capped for inflation exceeding an 8 percent annual average. |
| 4. Accounting conventions | | | | |
| *a. Half-year convention* | (a) The statutory schedules for personal property reflect a half-year convention that results in a half-year depreciation allowance for the first recovery year, regardless of when property is placed in service during the year. | (a) The depreciation allowance for the first year would be based on the number of months the asset was in service. | (a) For personal property, both the first and last depreciation allowances for an asset would reflect the half-year convention. | (a) Same as House bill. |
| *b. Mid-month convention* | (b) Under a mid-month convention, real property (other than low-income housing) placed in service or disposed of at anytime during a month is treated as having been placed in service or disposed of in the middle of the month. | (b) The same mid-month convention that applies to most real property under present law would apply to all property. | (b) For Class 10 property and low-income housing, apply the present-law mid-month convention. For other property, apply the mid-month convention to taxpayers who place more them 40 percent of property in service during the last quarter of the taxable year. | (b) The present-law mid-month convention would apply to 30-year real property, and to other property held by taxpayers who place more than 40 percent of property in service during last quarter of taxable year, as under the House bill. |
| 5. Gain on disposition<br>*a. In general* | (a) With limited exceptions, gain is "recaptured" as ordinary income to the extent of previously allowed depreciation deductions. Gain in excess of amounts subject to recapture is treated as capital gain. These rules have no application to nondepreciable property used in a trade or business (such as land). | (a) All gain on disposition of depreciable property would be taxed as ordinary income. | (a) Retain present law. | (a) All gain on disposition of depreciable property, to the extent of previously taken depreciation, would be taxed as ordinary income.<br>*Effective date.*—Assets placed in service after December 31, 1986, except for property eligible for the transition rules in II.A.11.c., below. |
| *b. Residential real property* | (b) For residential real property held for more than one year, gain is recaptured only to the extent that accelerated depreciation deductions exceed straight-line deductions. Recapture for low-income housing is phased out after property has been held for a prescribed period. | (b) No special provision. | (b) For low-income housing, only the excess of IDS deductions over straight line deductions (over the applicable recovery period) is recaptured, and the phaseout of recapture is repealed. For property that ceases to qualify as low-income housing after a sale-leaseback, Treasury is granted regulatory authority to determine the recapture amount by reference to straight line depreciation over 30 years. For other residential real property that is 30-year property, there is no recapture. | (b) No special provision. |
| *c. Nonresidential real property* | (c) There is no recapture if the taxpayer elected to recover the property's cost using the straight-line method. Otherwise, the full amount of depreciation—to extent of gain—is recaptured. | (c) No special provision. | (c) For nonresidential 30-year real property, there is no recapture. | (c) No special provision. |

## II. ACCELERATED COST RECOVERY SYSTEM AND INVESTMENT TAX CREDIT—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| 6. Lessee leasehold improvements | A lessee recovers the cost of leasehold improvements over the shorter of the property's ACRS recovery period or the portion of the lease term remaining on the date the property is acquired. Under statutory rules provided for use in determining the term of a lease, in certain cases, a lease term includes periods during which the lease may be renewed pursuant to an option held by the lessee, unless the lessee establishes that it is more probable than not that the lease will not be renewed. In other cases, the statute provides that a lease term is determined by excluding renewal options held by the lessee, unless the facts show with reasonable certainty that the lease will be renewed. These rules also apply in determining the amortization period for lease acquisition costs. | The cost of leasehold improvements made by a lessee would be recovered under the general rules, without regard to the lease term, except where the improvement is reasonably expected to have no residual value on expiration of the lease. | A lessee would recover capital costs under the general rules in every case. | Same as House bill. The statutory rules for determining the term of a lease the only future relevance of which would be in determining the amortization period for lease acquisition costs—would be amended to provide that the term of a lease is determined by including all renewal options as well as any period for which the parties reasonably expect the lease to be renewed. |
| 7. Repair allowances | Expenditures that prolong the life of an asset are recoverable in the same manner as the cost of a capital asset. Other expenditures for repair or maintenance are expensed. The characterization of an expense as a capital expenditure or a deductible repair requires a factual determination. | Each asset class would be assigned a safe-harbor repair allowance factor. A taxpayer would automatically deduct expenses to the extent the expenses do not exceed the product of the asset's inflation-adjusted basis multiplied by the repair allowance factor. | Retain present law. | Retain present law. |
| 8. Expensing | Taxpayers can elect to expense up to $5,000 of the cost of personal property that is purchased and used in a trade or business. The $5,000 ceiling is scheduled to increase to $7,500 for taxable years beginning in 1988 and 1989, and to $10,000 for years beginning after 1989. The dollar limitation is subject to apportionment among certain related entities. If expensed property is converted to nonbusiness use within two years of the time the property was placed in service, the difference between the amount expensed and the ACRS deductions that would have been allowed for the period of business use is recaptured as ordinary income. | The scheduled increases in the ceiling would be repealed. | Provide a $10,000 ceiling and limit eligibility for expensing to taxpayer whose total investment in tangible personal property for taxable year is $200,000 or less. | Provide a $50,000 ceiling and limit eligibility for expensing up to $50,000 to taxpayers whose total investment in tangible personal property for taxable year is $200,000 or less. For other taxpayers, for every dollar of investment in excess of $200,000, reduce the $50,000 ceiling by one dollar. Recapture the difference between expensing and ACRS deductions if property is converted to nonbusiness use at any time before the end of the property's recovery period. |
| 9. Vintage accounts | Taxpayers generally compute depreciation deductions on an asset-by-asset basis. There is an election to establish mass asset vintage accounts for assets in the same recovery class and placed in service in the same year. The definition of assets eligible for inclusion in mass asset accounts is limited, primarily because of concern about the mechanics of recapturing investment tax credit. | Mass asset vintage accounts would be retained for property qualifying for such treatment under ACRS. | With repeal of the investment tax credit, the definition of eligible property would be expanded to include all property. | Same as House bill. |

## II. ACCELERATED COST RECOVERY SYSTEM AND INVESTMENT TAX CREDIT—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **10. Public utility property** | The benefits of accelerated depreciation must be normalized. | Same as present law. | Same as present law; also, normalization rules are applied to excess deferred tax reserves resulting from the reduction of corporate income tax rates. | Same as House bill. |
| **11. Effective date** | | | | |
| ***a. In general*** | | (a) CCRS would be effective for property placed in service on or after January 1, 1986. | (a) Same as President's proposal. | (a) Effective for property placed in service on or after January 1, 1987. |
| ***b. Anti-churning rules*** | | (b) Under rules similar to those enacted as part of ACRS, taxpayers would be prevented from bringing property placed in service before the effective date under CCRS by certain post-effective date transactions among related parties. | (b) No provision. | (b) Provide rules similar to President's proposal. |
| ***c. Transition rules*** | | (c) No provision. | (c) ACRS would apply to:<br>(1) property that is constructed, reconstructed, or acquired pursuant to a written contract that was binding as of September 25, 1985, or<br>(2) property constructed or reconstructed by the taxpayer, if the lesser of $1 million or 5 percent of cost has been incurred or committed by September 25, 1985, if construction commenced by that date, or<br>(3) an equipped building or a plant facility, if construction has commenced as of September 25, 1985, pursuant to a written specific plan, and more than half of the cost has been incurred or committed by that date, and<br>(4) property or project is placed in service by July 1, 1986, in the case of Class 1 property, cars, and light general purpose trucks; by January 1, 1987, in the case of Class 2 property; by January 1, 1989, in the case of Class 3-6 property; and by January 1, 1991, in the case of Class 7-10 property.<br>(5) ACRS would apply to property that qualifies under (1), (2), or (3) and (4), but is sold and leased back by the person initially committed to acquire the property within a 3-month window.<br>(6) special transitional rules are provided for certain multi-use urban projects, mass commuting vehicles, solid waste disposal facilities, properties included in master plans of integrated projects, and projects that were approved by the Federal Energy Regulatory Commission, *inter alia.* | (c) Present law ACRS would apply to property with an ADR midpoint of 7 years or greater (other than computer-based telephone central office switching equipment) that is:<br>(1) constructed, reconstructed, or acquired pursuant to a written contract that was binding as of March 1, 1986, or<br>(2) constructed or reconstructed by the taxpayer, if the lesser of $1 million or 5 percent of cost has been incurred or committed by March 1, 1986, if construction commenced by that date, or<br>(3) an equipped building or a plant facility, if construction has commenced as of March 1, 1986, pursuant to a written specific plan, and more than half of the cost has been incurred or committed by that date, and<br>(4) such property is placed in service by January 1, 1989 in the case of property with an ADR midpoint less than 20 years; and by January 1, 1991 in the case of property with an ADR midpoint of 20 years and greater and 30-year class real property, and<br>(5) Present law ACRS would apply to property that qualifies under (1), (2), or (3) and (4), but is sold and leased back by the person initially committed to acquire the property within a 3-month window. |

## II. ACCELERATED COST RECOVERY SYSTEM AND INVESTMENT TAX CREDIT—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **B. Windfall Recapture of Excess Accelerated Depreciation** | Taxpayers who defer tax liability by taking accelerated depreciation deductions at present law rates normally pay the deferred taxes only when and as the investment either produces taxable income or is disposed of at a gain. | Taxpayers who deferred tax liability by taking accelerated depreciation deductions at present-law rates would include 40 percent of "excess depreciation" (i.e., the excess of accelerated depreciation deductions over depreciation allowances for purposes of computing earnings and profits) in income over a three-year period.<br>*Effective date.*—The proposed recapture rule would apply to excess depreciation taken between January 1, 1980, through June 30, 1986. Certain dispositions before July 1, 1986, would be disregarded. | No provision. | No provision. |
| **C. Regular Investment Tax Credit**<br>**1. Allowable credit** | A credit against income tax liability is allowed for up to ten percent of a taxpayer's investment in tangible personal property (six percent for proprety in the three-year ACRS class). | The regular investment tax credit would be repealed. | Same as President's proposal. | Same as President's proposal. |
| **2. Public utility property** | For public utility property, the tax benefits of the credit must be normalized. | Normalization rules would be retained for the unamortized portion of investment tax credits allowed to public utilities. | Same as President's proposal. | Same as President's proposal. |
| **3. Effective date**<br>***a. General*** | | (a) Repeal would be effective for property placed in service on or after January 1, 1986. | (a) Same as President's proposal. | (a) Repeal would be effective for property placed in service on or after March 1, 1986. |
| ***b. Transition rules*** | | (b) No provision. | (b) The credit would be available under the same circumstances in which present-law depreciation rules would continue to apply.<br>A taxpayer would spread the credit earned on transition property ratably over 5 years. A basis adjustment would be required for the full investment credit in the first taxable year. | (b) The credit would be available under the same circumstances in which present law depreciation rules would continue to apply. The credit earned on transition property would be available under the conditions proposed for credit carryovers. (See II.D., below.) |

## II. ACCELERATED COST RECOVERY SYSTEM AND INVESTMENT TAX CREDIT—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **D. Mandatory Refund of Unused ITC Carryovers** | Unused investment tax credits are allowed a three-year carryback and a 15-year carryforward. Credits that are not used before the end of the carryforward period expire. | No provision. | No provision. | 70 percent of investment credit carryovers existing as of the beginning of the first taxable year beginning after the effective date (see C.3.*a*., above) of termination of the credit would be treated as a payment against tax for such year (made on the last day prescribed for filing the return for such year, determined without regard to extensions). A similar rule would apply to a taxable year in which credits are claimed under transitional rules. The provision would not affect the requirement that a half basis adjustment be computed by reference to the full amount of credit earned. |
| **E. Finance Leases** | Under the finance lease rules, the fact that a lessee has a fixed-price option to purchase the property or the leased property is limited use property is not taken into account in determining whether the agreement is a lease. The finance lease rules are scheduled to go into effect after December 31, 1987, although the rules are available currently for limited categories of property. | No provision. | Repeal the finance lease rules.<br>*Effective date.*—Agreements entered into on or after January 1, 1986 (for property that qualifies for finance lease transition rules under prior tax acts, January 1, 1988). | Same as House bill.<br>*Effective date.*—Agreements entered into on or after January 1, 1987 (for property that qualifies for finance lease transition rules under prior tax acts, January 1, 1988). |
| **F. Multi-Family Residential Rental Credit (*See also XVI.C.2.*)** | Low-income housing is eligible for accelerated depreciation (using a shorter recovery period and a more accelerated method that those applicable to other real property). The cost of low-income housing that is tax-exempt financed is recovered using the straight-line method over a shorter recovery period than that applicable to other real property. | No special provision. | Present law is retained, but modified. | The special depreciation and tax-exempt financing rules are replaced by a special low-income housing tax credit. (See item XVI.C.2., below.) |

## III. ACCOUNTING ISSUES

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **A. Simplified Dollar Value LIFO Method for Certain Small Businesses** | A taxpayer whose average annual gross receipts do not exceed $2 million may elect to use a single, dollar value LIFO inventory pool for any trade or business. Under regulations, a taxpayer using the dollar value LIFO method may use data published by the Bureau of Labor Statistics to construct an individualized index that estimates the annual change in prices for items in an inventory pool. | No provision. | A taxpayer whose average annual gross receipts do not exceed $5 million may elect to use a simplified method of determining dollar value LIFO inventory values. The method establishes inventory pools in accordance with general categories of inventory items published by the Bureau of Labor Statistics and uses the change in the published index for the category to estimate the annual change in prices for inventory items in the pool. | Same as House bill. |
| | | | *Effective date.*—Taxable years beginning after December 31, 1985. | *Effective date.*—Taxable years beginning after December 31, 1986. |
| **B. Limitations on the Use of the Cash Method of Accounting** | (a) A taxpayer may elect to use any method of accounting that clearly reflects income and is regularly used in keeping its books. The cash receipts and disbursements method (the cash method) generally is considered to clearly reflect income for Federal income tax purposes under present law, except where inventories are required to be kept. | (a) Any taxpayer with annual gross receipts from a business exceeding $5 million, computed on a 3-year moving average basis, would not be permitted to use the cash method of accounting for Federal income tax purposes. For businesses other than farming, use of the cash method also would be disallowed if another method of accounting has been used regularly to ascertain the income, profit or loss of the business for the purpose of reports or statements to shareholders, partners, other proprietors, beneficiaries, or for credit purposes.<br>The proposal would apply in addition to the current law limitation on the use of the cash method with respect to a business in which inventory accounting is required. | (a) The cash method of accounting generally may not be used by any C corporation, partnership that has a C corporation as a partner, or tax-exempt trust with unrelated business income. Exceptions are made for farming businesses, qualified personal service corporations, and entities with average annual gross receipts of $5 million or less. Computation of average annual gross receipts is done on the basis of the 3 previous taxable years (not including the current taxable year). | (a) Same as the House bill except that tax shelters (as defined in section 461(i)) would not be allowed to use the cash method. |
| | (b) An accrual basis taxpayer must accrue an amount as income when all the events have occurred which fix the right to receive such income and the amount can be determined with reasonable accuracy. | (b) No provision. | (b) A taxpayer is not required to accrue as income any amount to be received for the performance of services prior to the time the amount is billed or which, on the basis of experience, will not be collected, so long as unpaid balances do not bear interest or result in a late payment charge. An accrual basis recipient of services generally may not treat the services as economically performed prior to the time of billing. | (b) Retain present law, except that a taxpayer is not required to accrue as income any amount to be received for the performance of services which, on the basis of experience, will not be collected, so long as unpaid balances do not bear interest or result in a late payment charge. |
| | | *Effective date.*—Taxable years beginning on or after January 1, 1986. The adjustment to income resulting from the change in tax accounting method would be recognized ratably over a period not to exceed 6 years beginning with the first tax year for which the proposal is effective. | *Effective date.*—Taxable years beginning on or after January 1, 1986. The adjustment to income resulting from the change in tax accounting method is recognized ratably over a period not to exceed 5 years (not to exceed 10 years in the case of a hospital). Taxpayers may elect to continue to report income from loans, leases and transactions with related persons entered into before September 25, 1985, using the cash method. | *Effective date.*—Taxable years beginning after December 31, 1986. The adjustment to income resulting from the change in accounting method would be recognized ratably over a period not to exceed 5 years beginning with the first taxable year for which the proposal is effective. |

BEST COPY AVAILABLE

## III. ACCOUNTING ISSUES—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **C. Installment Sales** | A taxpayer who sells property in exchange for deferred payments generally may report income on the installment method. Generally, under the installment method, gain is reported in proportion to the payments received on the outstanding installment obligations. Under Treasury regulations, a portion of sales made on a revolving credit plan are treated as installment sales eligible for reporting on the installment method.<br>The portion of sales made on a revolving credit plan that may be treated as sales eligible for installment reporting is that portion of the sales that contemplate payments being made in two or more installments and that are in fact paid for in two or more installments. The determination of this portion is made on the basis of a statistical sample of the revolving credit accounts.<br>A revolving credit plan includes cycle budget accounts, flexible budget accounts, continuous budget accounts and other similar plans or arrangements under which the customer agrees to pay during each period of time for which a periodic statement of charges and credits is rendered, a part of the outstanding balance of the customer's account. | *General rule.*—If an installment obligation is pledged for a loan, the proceeds of the loan generally would be treated as payment on the obligation, and proportionate amounts of deferred gain would be recognized.<br>*Special rule for dealer property.*—If installment obligation received for property sold in the ordinary course of a trade or business is pledged for loan in ordinary course of trade or business, proceeds of the loan would trigger gain to the extent the loan proceeds exceed the basis of the obligation.<br>*Subsequent payments.*—Payments by obligor on an installment obligation would trigger additional gain to the extent that the gain attributable to such payments exceeds gain recognized on account of the pledge.<br>*Exceptions.*—Inapplicable to pledge of an obligation that by its terms is due within 12 months, or an obligation received under a revolving credit plan that contemplates all purchases would be paid for within 12 months. Also inapplicable to pledges of obligations for debt that by its terms is payable within 90 days, provided that debt is not renewed or continued. Also inapplicable to indebtedness owed to a financial institution and secured by a general lien on all of the borrower's trade or business assets, except if substantially all the borrower's assets are installment obligations.<br>*Effective date.*—Applicable to obligations pledged after December 31, 1985. Any installment obligation pledged before January 1, 1986, would be treated as pledged on January 1, 1991, if still outstanding. | Same as President's proposal, except—<br>Pledges of installment obligations received for property sold in the ordinary course of a trade or business are treated the same as the pledges of other installment obligations under proposal.<br>An exception is provided for any installment payments that are due within 9 months regardless of the maturity of other payments on the obligation. For a taxpayer who sells property on a revolving credit plan, the amount eligible for the exception is that portion of the receivable balance that is determined (pursuant to a statistical sampling technique) to be paid in 9 months.<br>The exception for 90-day debt is allowed only if the taxpayer does not issue additional debt within 45 days.<br>Anti-avoidance rules are included subjecting a borrowing to the pledging rule if it is reasonable to expect that the lender took into account payments on the installment obligations as a source for payments on the indebtedness, but a safe harbor is provided where more than 50 percent of the taxpayer's assets are used in an active trade or business.<br>*Effective date.*—Applicable to obligations pledged after December 31, 1985, and applicable to obligations created after September 25, 1985, if pledged for a debt obligation outstanding after December 31, 1985. The provision is phased in over 3 years for installment obligations arising from the sale of property in the ordinary course of business that are pledged in 1986, and phased in over 2 years for like installment obligations pledged in 1987. One residential condominium project is grandfathered. | The use of the installment method is denied for a portion of sales of dealers in personal property (other than sales under revolving credit plans). The disallowed portion is that portion that bears the same ratio to the total installment sales that the taxpayer's outstanding debt bears to the adjusted basis of the taxpayer's assets. An exception is provided for sales by a manufacturer to a dealer where the term of the dealer's obligation is dependent upon the time that the property is resold or is rented by the dealer, the manufacturer has the right to repurchase the property if the dealer does not resell or rent the property within a specified period, and the amount of the manufacturer's installment obligations exceeds the manufacturer's net worth.<br>Use of the installment method for sales made pursuant to a revolving credit plan and for sales of publicly traded property is eliminated.<br>*Effective date.*—The elimination of the installment method for sales on a revolving credit plan and for sales of publicly traded property is effective for sales of property after December 31, 1986. Taxpayers who sell property on a revolving credit plan and who may no longer use the installment method of accounting for revolving credit plans may include the resulting adjustment in income over a period not exceeding five years.<br>The proportionate denial of the installment method for dealers in personal property is effective as of January 1, 1987 with respect to sales made on or after March 1, 1986. |

## III. ACCOUNTING ISSUES—(Continued)

| Item | Present Law | President's Proposal | House Bill | Finance Committee Staff Option |
|---|---|---|---|---|
| **D. Capitalization of Inventory, Construction, and Development Costs** *(See also secs. VII.A.2. and B.2., relating to costs incurred in farming, ranching, and timber activities)*<br>**1. Inventory** | Manufacturers generally must accumulate costs of producing "inventory" goods in an inventory account. Costs in the inventory account may be deducted only as the goods to which they relate are disposed of.<br>Under regulations, the "full absorption method" determines which costs are includible in inventory. All direct production costs, including costs of materials incorporated into the product or consumed during production and labor directly involved in manufacturing, must be inventoried. The treatment of indirect production costs varies according to the nature of the cost: some costs are deductible; others are inventoriable; others ("financial conformity" costs) are deductible only if deducted by the taxpayer for financial reporting purposes.<br>Purchasers of goods for resale (e.g., wholesalers and retailers) must include in inventory the invoice price of the purchased goods plus transportation and other necessary costs incurred in acquiring possession. | Comprehensive capitalization rules (hereinafter, the "uniform capitalization rules") would apply to the manufacture of inventory goods. These rules would essentially parallel the full absorption rules, but would require that most financial conformity costs be inventoried. In addition, all tax depreciation, current pension and fringe benefit costs, and a portion of general and administrative expenses would be treated as inventory costs. However, research and experimental costs (within the meaning of sec. 174) would not be subject to capitalization in the case of inventory. | Same as President's proposal. | Same as President's proposal, except that purchasers of goods for resale would generally be subject to the uniform capitalization rules. Thus, costs (including general and administrative costs) attributable to purchasing, transporting, repackaging or other processing, and storage of goods, and other similar costs associated with the goods, would be treated as inventory costs. |
| **2. Self-constructed property and noninventory property produced for sale** | The costs of acquiring, constructing, or improving buildings, machinery, equipment, or other assets having a useful life beyond the end of the taxable year are not currently deductible. These "capital expenditures" become part of the basis of the asset, and may be recoverable over the useful life of the property through depreciation or amortization deductions if the property is held for business or investment purposes. Any unrecovered basis may be offset against the amount realized if the property is sold.<br>Although a taxpayer's direct costs of constructing an asset for its own use or a noninventory asset produced for sale must be capitalized, the proper treatment of many indirect costs is uncertain. | Cost (other than research and experimental costs) incured in connection with construction of noninventory property and self-use property would be subject to the uniform capitalization rules. | Same as President's proposal. | Same as President's proposal. |

## III. ACCOUNTING ISSUES—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| 3. Long-term contracts | The treatment of costs of producing property under a "long-term contract" varies depending on the method of accounting used by the taxpayer. In addition to an inventory method (described above), taxpayers may use two special methods of accounting for long-term contracts: the percentage of completion method and the completed contract method. Under the percentage of completion method, gross income is recognized according to the percentage of the contract completed during each taxable year, and contract costs are currently deductible. Under the completed contract method, the gross contract price is included in income, and cost associated with the contract may be deducted, in the year that the contract is completed and accepted.<br>The rules relating to which costs are contract costs vary depending on whether the contract is an extended period contract (in general, a contract requiring longer than 2 years to complete) or a non-extended period contract. The rules applicable to extended period contracts are essentially the same as the uniform capitalization rules. Non-extended period contracts are subject to similar but somewhat less comprehensive rules. | All long-term contracts would be subject to the uniform capitalization rules under the completed contract method. In addition, all general and administrative costs attributable to cost-plus contracts, and to Federal government contracts requiring certification of costs, would be treated as contract costs. | Provides that all long-term contracts must be reported under the percentage of completion method. Thus, long-term contract costs would be currently deductible to the extent attributable to contracts reported under the percentage of completion method. An exception is provided for contracts for the construction of real property to be completed within 2 years of the contract date, if performed by a taxpayer whose average annual gross receipts do not exceed $10 million. Present law capitalization rules would be retained for contracts not required to be reported under the percentage of completion method. | Same as President's proposal, but retain present law for real property construction contracts not requiring more than 2 years to complete, if performed by a taxpayer with average annual gross receipts of $10 million or less. |
| 4. Interest | Interest incurred by a taxpayer during construction or improvement of real property held for business or investment purposes generally must be capitalized and amortized over 10 years. An exception is provided for low-income housing. | Capitalization would be required for interest on debt incurred to finance the construction or manufacture of (1) long-lived personal and real property or (2) tangible property requiring 2 or more years to construct or manufacture. There would be no exception for low-income housing. | Same as President's proposal, except interest incurred to finance the construction or manufacture of property costing more than $1 million would also be capitalized. | Same as House bill. (See XVI.C.2. for the special credit for low-income housing.) |
| 5. Effective date | | In general, costs and interest incurred after December 31, 1985. For inventories, the rules would apply to taxable years beginning after December 31, 1985. The section 481 adjustment would be spread ratably over a period of not more than 6 years under the rules applicable to a change in a method of accounting initiated by the taxpayer. | Same as President's proposal, except the section 481 adjustment would be spread over a period of not more than 5 years, and the change to the percentage of completion method would apply to contracts entered into after September 25, 1985. | The provisions would generally be effective for costs and interest incurred after December 31, 1986. For inventories, the rules would apply to taxable years beginning after December 31, 1986. The section 481 adjustment would be spread ratably over a period not to exceed 5 years under the rules applicable to a change in a method of accounting initiated by the taxpayer. For long-term contracts, the rules would apply to contracts entered into on or after March 1, 1986. |

## III. ACCOUNTING ISSUES—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| E. Special Treatment of Certain Items | | | | |
| 1. Reserves for bad debts | A taxpayer may take a deduction for losses on business debts under the "reserve method" (sec. 166(c)). The "reserve method" allows a current deduction for that portion of business debts currently owed the taxpayer which are expected to become uncollectible.<br>A similar rule applies to debt that is guaranteed by a dealer in property where the debt arises from the sale of tangible property and related services in the ordinary course of business. | The use of the reserve method in computing the deduction for bad debts would be disallowed. Instead, deductions for bad debts would be allowed when specific loans become partially or wholly worthless (i.e., the "specific charge-off" method). Wholly worthless debts would have to be treated as worthless on a taxpayer's books in order for a deduction to be allowed for Federal income tax purposes, as is the case under present law for partially worthless debts. Retains present law on guarantees by a dealer in property.<br>*Effective date.*—Taxable years beginning on or after January 1, 1986. The balance in any reserve for bad debts at that time would be included in income ratably over a 10-year period beginning with the first taxable year beginning on or after January 1, 1986. | Same as President's proposal except that the balance in any reserve for bad debts on the effective date of the provision is to be included in income ratably over a 5-year period. | Same as House bill, except that use of the reserve method in computing the deduction for losses on debts guaranteed by a dealer would also be disallowed. The proposal would be effective for taxable years beginning after December 31, 1985. |

## III. ACCOUNTING ISSUES—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **2. Returns of magazines, paperbacks and records** | An accrual-basis taxpayers may elect to exclude from gross income amounts attributable to "qualified sales" of magazines, paperbacks or records which are repaid or credited to the purchaser before the close of the "merchandise return period" (sec. 485). A "qualified sale" is a sale for which, at the time of the sale, the taxpayer has a legal obligation to adjust the sales price of the item if it is not resold, and which is in fact so adjusted. The merchandise return period is 2 months and 15 days following the close of the taxable year for magazines, and 4 months and 15 days following the close of the taxable year for paperbacks and records.<br>For the first year to which an election applies, special rules delay a portion of the exclusion to limit the bunching of exclusions that might otherwise occur. | The election to exclude from gross income amounts attributable to the qualified sales of magazines, paperbacks or records which are repaid or credited after year end, but before the close of the merchandise return period, would be repealed.<br>Any amount of exclusion delayed in the first year of election, which has not yet been allowed as an exclusion, would be treated as a deduction in the first taxable year for which the proposal is effective.<br>*Effective date.*—Taxable years beginning on or after January 1, 1986. | Retain present law. | Retain present law. |
| **3. Qualified discount coupons** | An accural-basis taxpayer may elect to deduct the cost of redeeming "qualified discount coupons" outstanding at the close of the taxable year and received for redemption up to 6 months following the close of the taxable year (sec. 466). A "qualified discount coupon" is one which is issued and redeemable by the taxpayer and which allows a discount of not more than $5 on the purchase price of mechandise or other tangible personal property. For the first year to which an election applies, a special rule delays a portion of the deduction attributable to the election to prevent a bunching of deductions. | The election to deduct the cost of redeeming "qualified discount coupons" resolved after the close of the taxable year would be repealed. Any portion of the delayed deduction from the first year of election, which has not yet been allowed as a deduction, would be deductible in the first taxable year for which the proposal is effective.<br>*Effective date.*—The proposal would be effective for taxable years beginning on or after January 1, 1986. | Retain present law. | Same as President's proposal, except that the proposal would be effective for taxable years beginning after December 31, 1986. |

## IV. CAPITAL GAINS

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **A. Individual Capital Gains** | An individual may deduct from gross income 60 percent of net capital gain (the excess of net long-term capital gain over any net short-term capital loss). Since the maximum regular individual tax rate is 50 percent, the deduction means that net capital gain is taxed at a maximum rate of 20 percent. The alternative minimum tax, which applies only if greater than the regular tax, is also 20 percent. Thus, although the deducted portion of capital gains is a preference item, the alternative minimum tax does not increase the maximum rate on net capital gain. | (1) 50 percent of an individual's net capital gain would be deductible. Since the highest regular tax rate for individuals would be 35 percent, the highest rate applicable to such net capital gain would be 17.5 percent. However, taxpayers subject to the alternative minimum tax would be potentially subject to a 20 percent rate on net capital gain.<br>(2) For sales after 1990, individuals could elect annually to compute gain by indexing the basis of capital assets, instead of deducting a portion of unindexed gain from gross income.<br>*Effective date.*—July 1, 1986. A taxpayer with a fiscal year that includes but does not begin on July 1, 1986 would use a blended percentage deduction for sales at any time during the year 1986. | (1) 42 percent (50 percent in 1986) of an individual's net capital gain would be deductible. Since the highest regular rate for the individuals would be 38 percent, the highest rate applicable to such net capital gain would be 22.04 percent.<br>(2) No indexing the basis of capital assets.<br>*Effective date.*—Taxable years beginning after December 31, 1985. | (1) 3/7 (9/17 in 1987) of an individual's net capital gain would be deductible. Since the highest regular rate for individuals would be 35 percent, the highest rate applicable to such net capital gain would be 20 percent.<br>(2) No indexing the basis of capital assets.<br>*Effective date.*—Taxable years beginning after December 31, 1986. |
| **B. Corporate Capital Gains** | An alternative tax rate of 28 percent applies to a corporation's net capital gain if the tax would be lower than the tax using the regular graduated rates. | Retain present law. | The alternative tax on corporate net capital gain is repealed. Thus, corporate net capital gain is taxed at regular corporate rates.<br>*Effective date.*—The change in the alternative tax for corporate capital gain generally applies to gain properly taken into account on or after January 1, 1986, unless pursuant to a sale that was made on or before September 25, 1985, or that was pursuant to a written binding contract in effect on that date. | Retain present law. |
| **C. Incentive Stock Options** | An employee is not taxed on the exercise of an incentive stock option and is entitled to capital gains when the stock is sold.<br>In order for options to qualify as incentive stock options, among other requirements, the options must be exercisable in the order they are granted, and the employer may not grant the employee such options to acquire stock with a value of more than $100,000 (increased by certain carryover amounts) in any one year. | No provision. | No provision. | (1) The requirement that the options be exercisable in the order granted would be repealed.<br>(2) The $100,000 limitation would be modified to apply to options first exercisable during the year.<br>(3) A corporation with gross profits (gross sales less cost of goods sold) in excess of $100 million in the previous year could not issue incentive stock options.<br>*Effective date.*—Options issued after 1986. |

## IV. CAPITAL GAINS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **D. Small Business Participating Debentures** | Interest paid on indebtedness generally is deductible by the borrower and is includible as ordinary income by the lender.<br>Loss on the sale or exchange of stock in a "small business corporation" is treated as ordinary loss up to $50,000 ($100,000 for a joint return). A small business corporation is a domestic corporation the amount of whose paid-in capital does not exceed $1 million and which did not receive more than 50 percent of its aggregate gross receipts from certain passive sources in the preceeding five years. | No provision. | No provision. | Interest on a "small business participating debenture" is deductible by the borrower. Such interest is treated as ordinary income to the lender to the extent of any fixed portion, and is treated as capital gain to the extent of any portion based on the earnings of the borrower.<br>In general, a small business participating debenture is a debt obligation that is issued by a "qualified small business" and that has a fixed maturity, a minimum stated interest rate, and provides for payments to the lender based on the earnings of the borrower. The borrower and the lender may not be related persons and the lender must be a U.S. person, or a foreign person that treats the income as effectively connected with a U.S. trade or business. No issuer may have more than $1 million of small business participating debentures outstanding.<br>A qualified small business generally is a corporate business that has paid-in capital not exceeding $1 million and that is not controlled by a foreign person. The corporation must not have derived more than 50 percent of its aggregate gross receipts in the preceeding five years from specified passive sources. Qualified small business also includes a noncorporate business that meets requirements similar to those for corporations.<br>Losses on the sale or exchange of a small business participating debenture are treated the same as losses on the sale or exchange of small business corporation stock, i.e., a limited amount of such losses is eligible for ordinary loss treatment.<br>Anti-avoidance rules are provided.<br>*Effective date.*—The provision is effective for small business participating debentures issued after December 31, 1986 and before January 1, 1990. |

## IV. CAPITAL GAINS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **E. Straddles**<br>**1. Mark-to-market system** | (a) Section 1256 contracts (regulated futures contracts, certain listed options, and forward contracts traded in the interbank market) are marked to market at the close of the taxable year, with gain taxed as 60-percent long-term and 40-percent short-term (for a maximum tax rate of 32 percent). | (a) No provision. | (a) No provision. | (a) Tax gains under the mark-to-market regime as 100 percent short-term capital gains (two-thirds short-term capital gains during 1987), for a maximum tax rate of 35 percent (the proposed top rate).<br>*Effective date.*—Positions established on or after Janurary 1, 1987. |
| **2. Year-end rule for qualified covered calls** | (b) A loss-deferral rule applies to a straddle consisting of stock offset by an option, subject to an exception for qualified covered call options. The qualified covered call exception is denied to a taxpayer who fails to hold stock for 30 days after the related call option is disposed of at a loss, where gain on sale of the stock is included in the subsequent year. | (b) No provision. | (b) No provision. | (b) Apply the year-end rule to cases in which stock is sold at a loss and gain on the option is included in the subsequent year.<br>*Effective date.*—Positions established on or after January 1, 1987. |

## V. COMPLIANCE AND TAX ADMINISTRATION

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| A. Increased Penalties<br>**1. Penalties relating to information returns** | The Code provides a $50 penalty for each failure to file an information return with the IRS and each failure to supply a copy of the information return to the taxpayer. The maximum penalty is generally $50,000, except in cases of intentional disregard.<br>The Code also provides a $5 penalty ($50 under certain circumstances) for failure to furnish a correct taxpayer identification number. There is no specific penalty for including other incorrect information on an information return. | (a) Eliminate the $50,000 maximum,<br>(b) Impose a new $5 penalty for supplying incorrect information (with a reasonable cause exception), and<br>(c) Consolidate the existing penalty for failure to file information returns with the IRS with the existing penalty for failure to supply a copy of the information return to the taxpayer.<br>*Effective date.*—Returns due on or after January 1, 1986 (without regard to extensions). | Generally the same as the President's proposal, except provide a $100,000 maximum penalty ($20,000 for supplying incorrect information). | Same as House bill. Additionally, provide that the $20,000 maximum does not apply in cases of intentional disregard.<br>*Effective date.*—Returns due on or after January 1, 1987 (without regard to extensions). |
| **2. Penalty for failure to pay taxes**<br>***a. Penalty*** | (a) A taxpayer who fails to pay taxes when due must pay a penalty of one-half of one percent of the tax for the first month not paid. The penalty increases by one-half of one percent for each month the failure to pay continues, up to a maximum of 25 percent. | (a) Repeal present-law penalty. | (a) Increase the penalty for failure to pay from one-half of one percent to one percent per month (up to the 25 percent limit) after the taxpayer has been notified that the IRS will levy upon the taxpayer's assets to collect the past-due taxes. This is the point at which the IRS uses more expensive collection methods.<br>Improve the coordination of the penalty for failure to pay taxes with the penalty for failure to file a tax return.<br>*Effective date.*—Amounts assessed after December 31, 1985. | (a) Same as House bill.<br>*Effective date.*—Amounts assessed after December 31, 1986. |
| ***b. Cost of collection charge*** | (b) No provision. | (b) Replace the penalty for failure to pay taxes with a cost of collection charge. The goal of the proposal is to recover IRS' costs of collecting delinquent payments.<br>*Effective date.*—Returns due on or after January 1, 1986 (without regard to extensions). | (b) No provision. | (b) Require the Treasury to report to the Senate Finance and House Ways and Means Committees by March 1, 1987, with specific recommendations as to how the cost of collection charge described in the President's proposal is proposed to be implemented. |

## V. COMPLIANCE AND TAX ADMINISTRATION—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **3. Negligence and fraud penalties** | (a) The Code provides penalties for negligence and fraud. Both penalties have two components. The first is a time-sensitive component. The second is a specified percentage (5 percent for negligence, 50 percent for fraud) of the entire underpayment of tax if any portion of the underpayment is due to negligence or fraud.<br>(b) A special negligence penalty applies to failures to include on a tax return interest or dividends that were reported to the taxpayer on an information report, in the absence of clear and convincing evidence that there was no negligence.<br>(c) The general negligence penalty does not apply to all taxes imposed by the Code. | No provision. | (a) Apply the fraud penalty only to the portion of the underpayment of tax attributable to fraud; increase the 50 percent component of the fraud penalty to 75 percent.<br>(b) Apply the special negligence penalty to all failures to include on a tax return items subject to information reporting.<br>(c) Apply the general negligence penalty to all taxes imposed by the Code.<br>(d) Apply the negligence penalty only to the portion of the underpayment not subject to the fraud penalty.<br>*Effective date.*—Returns required to be filed on or after January 1, 1986. | (a) Same as House bill.<br>(b) Same as House bill.<br>(c) Same as House bill.<br>(d) Apply the negligence penalty only to the portion of the underpayment attributable to negligence and increase the 5-percent component of the negligence penalty to 10 percent.<br>*Effective date.*—Returns required to be filed on or after January 1, 1987. |
| **B. Interest Provisions**<br>**1. Interest rate** | Taxpayers must pay interest to the Treasury on underpayments of tax, and the Treasury must pay interest to taxpayers on overpayments of tax. Both the rate taxpayers pay to the Treasury and the rate the Treasury pays to taxpayers are the same rate. That rate is determined semiannually. The rate utilized is the prime rate. | No provision. | The interest rate that Treasury pays to taxpayers is the 3-month Treasury bill rate plus 2 percentage points. The interest rate that taxpayers pay to the Treasury is the 3-month Treasury bill rates plus 3 percentage points. The rate is adjusted quarterly.<br>*Effective date.*—Determinations of interest for periods after December 31, 1985. | Same as House bill.<br>*Effective date.*—Determinations of interest for periods after December 31, 1986. |
| **2. Interest on underpayments of accumulated earnings tax** | The Code imposes the accumulated earnings tax to prevent corporations from accumulating (rather than distributing) dividends with the intent of reducing or avoiding taxes. Interest is charged only from the date IRS demands payment of the tax, rather than the date the return was originally due to be filed. | No provision. | Charge interest on underpayments of the accumulated earnings tax from the date the return was originally due to be filed.<br>*Effective date.*—Returns due in or after 1986. | Same as House bill.<br>*Effective date.*—Returns due in or after 1987. |
| **3. Interest on tax refunds** | IRS pays interest on tax refunds unless the refund is issued within 45 days of the last date the return may be filed (generally April 15). | No provision. | No provision. | Require that IRS pay interest on tax refunds unless the refund is issued within 45 days of the date the return is actually filed.<br>*Effective date.*—Returns filed after December 31, 1986. |

## V. COMPLIANCE AND TAX ADMINISTRATION—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **C. Information Reporting Provisions** | | | | |
| **1. Information reporting on real estate transactions** | Brokers must, when required by Treasury regulations, file information reports on the business they transact for customers (sec. 6045). | No provision. | Real estate transactions must be reported. The reporting is to be done by the settlement attorney or other stakeholder. This would generally be the person responsible for closing the transaction.<br>*Effective date.*—Real estate transactions occurring on or after January 1, 1986. | Generally same as House bill. Reporting is to be done by the real estate broker or, if there is no real estate broker, by the person responsible for closing the transaction.<br>*Effective date.*—Real estate transactions occurring on or after January 1, 1987. |
| **2. Information reporting on persons receiving contracts from certain Federal agencies** | There is no provision that requires information reporting on persons receiving Federal contracts. | No provision. | Requires Federal executive agencies to file an information return on each person with which the agency enters into a contract.<br>*Effective date.*—Contracts signed on or after or in effect on or after January 1, 1986. | Same as House bill.<br>*Effective date.*—Contracts signed on or after or in effect on or after January 1, 1987. |
| **3. Information reporting on State and local taxes** | No provision requires State and local governments to provide information reports to the IRS and the taxpayer on payments of State and local income, real property, and personal property taxes. | No provision. | Any State or local government that imposes an income tax, a real property tax, or a personal property tax, must report to the individual who paid those taxes and to the IRS the amount of those taxes paid by that individual.<br>*Effective date.*—January 1, 1987. | Same as House bill, for income taxes only. |
| **4. Tax-exempt interest required to be shown on tax returns** | There is no requirement that all taxpayers report the amount of tax-exempt interest they receive on their tax returns. The individual income tax return (Form 1040) for 1985 does, however, require that taxpayers with taxable social security benefits report the tax-exempt interest they receive. | No provision. | Any person required to file a tax return must report on that return the amount of tax-exempt interest received or accrued during the taxable year.<br>*Effective date.*—Taxable years beginning after December 31, 1985. | Same as present law. |

## V. COMPLIANCE AND TAX ADMINISTRATION—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **D. Suspend Statute of Limitations During Prolonged Dispute With Third Parties** | There is generally a three-year statute of limitations on tax returns, except in cases of fraud, failure to file, or a sizeable understatement of income. The statute continues to run even if the IRS must obtain records held by third parties. If the IRS must litigate to obtain access to the third party records, the statute of limitations can expire prior to final determination as to the availability of the records. | No provision. | No provision. | If third party records are not produced within six months of an administrative summons, the statute of limitations is suspended until the issue is resolved.<br>*Effective date.*—Date of enactment. |
| **E. Tax Shelters**<br>**1. Tax shelter user's fee** | The costs of administering the tax law with respect to tax shelters is paid as part of the overall IRS budget, which is funded from general revenues. This cost is approximately $165 million annually, and includes audits, examination, appeals, litigation, and criminal investigation. No specific fee is imposed on tax shelters to offset this cost. | No provision. | No provision. | Require taxpayers who claim on tax returns cumulative net losses (plus three times the value of cumulative tax credits) that exceed cumulative actual cash invested in a tax shelter to pay a user's fee of 1 percent of the losses claimed and 3 percent of the credits claimed. (These percentages are set at a level that will raise revenue approximately equal to the IRS cost of administering the law with respect to tax shelters.)<br>"Tax shelter" is defined as:<br>(a) any enterprise required to register with a Federal or State securities agency (other than a C corporation),<br>(b) any syndicate more than 35 percent of the losses of which are allocable to limited partners or limited entrepreneurs, or<br>(c) any plan or entity the principal purpose of which is to avoid or evade Federal income taxes.<br>(These definitions are currently used in the Code for other purposes.)<br>This user's fee is non-deductible. Impose a penalty equal to the user's fee if the taxpayer does not pay the user's fee with the tax return.<br>*Effective date.*—Returns filed on or after January 1, 1987. |

## V. COMPLIANCE AND TAX ADMINISTRATION—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **2. Tax shelter registration** | Tax shelter organizers are required to register with the IRS tax shelters they organize, develop, or sell. A tax shelter is any investment for which the ratio of the deductions plus 200 percent of the credits to the cash actually invested is greater than 2 to 1. The investment also must be subject to Federal or State securities requirements or be privately placed with 5 or more investors. | No provision. | No provision. | Multiply the value of the credits by 300 percent, instead of 200 percent (to conform to rate changes).<br>*Effective date.*—Same as rate changes. |
| **3. Penalty for failure to register a tax shelter** | Specified tax shelters are required to register with the IRS and obtain a tax shelter identification number. The penalty for failure to register a tax shelter with the IRS is $10,000 or, if less, one percent of the aggregate amount invested in the tax shelter (but in no event less than $500). | No provision. | No provision. | Increase the penalty to the greater of one percent of the aggregate amount invested in the tax shelter or $10,000.<br>*Effective date.*—Date of enactment. |
| **4. Penalty for failure to report the tax shelter identification number** | If a taxpayer invests in a tax shelter that has a tax shelter identification number, the taxpayer is required to include that number on the tax return. The penalty for failure to do so is $50, unless the failure is due to reasonable cause. | No provision. | No provision. | Increase the penalty to $250.<br>*Effective date.*—Returns filed after date of enactment. |

BEST COPY AVAILABLE

## V. COMPLIANCE AND TAX ADMINISTRATION—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **5. Penalty for failure to maintain lists of investors** | Organizers and sellers of specified tax shelters are required to maintain lists of investors. The penalty for failure to do so is $50 for each name missing from the list, unless the failure is due to reasonable cause, up to a maximum of $50,000 per year. | No provision. | No provision. | Increase the penalty to $100 per name omitted, up to a maximum of $100,000 per year.<br>*Effective date.*—Date of enactment. |
| **6. Tax shelter interest** | If a taxpayer owes interest due to a substantial underpayment of tax (more than $1,000) attributable to a tax-motivated transaction (such as a tax shelter), interest is computed at 120 percent of the generally applicable rate. | No provision. | No provision. | Increase the rate to 200 percent of the otherwise applicable rate.<br>*Effective date.*—Interest accruing after January 1, 1987. |
| **F. Estimated Tax Payments by Individuals** | Individuals owing tax who do not have sufficient taxes withheld from their wages must make estimated tax payments. These payments must equal at least the lesser of 100 percent of last year's tax liability or 80 percent of the current year's tax liability. | No provision. | Require that individuals must make estimated tax payments that equal at least the lesser of 100 percent (as under present law) of last year's tax liability or 90 percent (rather than 80 percent) of the current year's tax liability.<br>*Effective date.*—Payments due for taxable years beginning on or after January 1, 1986. | Same as House bill.<br>*Effective date.*—Payments due for taxable years beginning on or after January 1, 1987. |

## V. COMPLIANCE AND TAX ADMINISTRATION—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **G. Tax Litigation and Tax Court**<br>**1. Awards of attorneys' fees in tax cases** | Attorneys' fees may be awarded in tax cases to private parties who prevail on the issues litigated if the taxpayer proves that the government's position was unreasonable. Awards are limited to $25,000. GAO has stated, however, that there is no appropriation currently available to pay Tax Court awards.<br>This provision expired with respect to court proceedings commenced after December 31, 1985. | No provision. | (a) Extend the present-law sunset date until December 31, 1989. | (a) The authorization of attorneys' fees and other court costs in tax cases is made permanent, with the following modifications:<br>(1) If it is determined that the taxpayer prevailed in the tax litigation, the burden rests on the Government to show that its position was substantially justified or that special circumstances exist that make an award of litigation costs unjust;<br>(2) The "substantially justified" standard applies to the administrative action or inaction by the Government on which such proceeding is based;<br>(3) No award is allowed to a prevailing party who unreasonably protracted the proceedings;<br>(4) The $25,000 cap is eliminated (as under present law, recoverable costs would not include costs of the administrative process); and<br>(5) Limits are imposed on hourly charges by attorneys and expert witness fees recoverable under the provision.<br>*Effective date.*—Actions commencing after December 31, 1985. |
| | | | (b) Authorize funding of attorneys' fee awards out of source used in non-tax cases. | (b) Same as House bill. |
| | | | (c) Give courts the authority to assess all or a portion of an attorneys' fee award against an IRS employee if the proceeding results from an arbitrary or capricious action of the employee. | (c) No provision. |

## V. COMPLIANCE AND TAX ADMINISTRATION—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| 2. Exhaustion of administrative remedies | A taxpayer may go directly to Tax Court without requesting review by the administrative appeals office within the IRS. After the case is opened in the Tax Court, it is sent to the IRS appeals office for settlement. Many of these cases are then settled without significant involvement by the Court. | No provision. | Authorize the Tax Court to impose a $120 penalty if the taxpayer has not used reasonable efforts to resolve his case administratively before going to court.<br>Require the Tax Court and IRS to report to Congress annually on Tax Court inventory and measures taken to close cases more efficiently.<br>*Effective date.*—Cases filed in the Tax Court after January 1, 1987. | No provision. |
| 3. Tax Court provisions<br>*a. Tax Court practice fee* | (a) The Tax Court imposes a $25 application fee prior to admission to practice before the Court. No fee is imposed after the application fee has been paid.<br>The Tax Court rules authorize the Court to initiate disciplinary proceedings against practitioners who appear before it. The Court is authorized to appoint outside counsel to pursue disciplinary matters. | (a) No provision. | (a) No provision. | (a) Authorize the Tax Court to impose a periodic registration fee on practitioners admitted to practice before it. The Tax Court is to establish the level of the fee and the frequency of its collection, but the fee may not exceed $30 per year. These funds would be available to the Tax Court to pay outside counsel engaged by the Court to pursue disciplinary matters.<br>*Effective date.*—January 1, 1987. |
| *b. Provide Tax Court with jurisdiction over late payment penalties* | (b) Provides a penalty if the taxpayer does not pay the taxes shown on the tax return. The Tax Court has held that it does not have jurisdiction over this penalty because it does not relate to a deficiency. | (b) No provision. | (b) No provision. | (b) Provide the Tax Court with jurisdiction over this late payment penalty.<br>*Effective date.*—Date of enactment. |
| *c. Provide Tax Court with assistance of U.S. Marshals* | (c) U.S. Marshals provide courtroom security, among other duties. It is not clear that the Tax Court has the authority to request the assistance of U.S. Marshals, because the Tax Court is an Article I (rather than Article III) court. | (c) No provision. | (c) No provision. | (c) Authorize that U.S. Marshals be available to the Tax Court in the same manner that they are available to other courts.<br>*Effective date.*—Date of enactment. |
| *d. Salary and travel expenses of Special Trial Judges* | (d)(1) The Chief Judge of the Tax Court is authorized to appoint Special Trial Judges, who assist in the work of the Court. The Code provides that their salary is determined by the procedures relating to the Commission on Executive, Legislative, and Judicial Salaries. The Executive Order implementing that provision fails to include Special Trial Judges.<br>(2) Prior to January 17, 1985, Special Trial Judges were entitled to reimbursement for travel expenses on the same basis as other Federal judges. On that date, the Comptroller General determined that they were entitled only to reduced reimbursement pursuant to the Federal Travel Regulations. | (d) No provision. | (d) No provision. | (d)(1) Provide that the salary of Special Trial Judges is 90 percent of the salary of Tax Court judges. (This is historically the level of their salary.)<br>(2) Provide that special Trial Judges are to be reimbursed for travel expenses at the same level as other judges.<br>*Effective date.*—Date of enactment. |

BLANK PAGE

BLANK PAGE

BLANK PAGE

## V. COMPLIANCE AND TAX ADMINISTRATION—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| *e. Tax Court Judges' retirement provisions* | (e) District Court judges meeting age and longevity of tenure requirements may resign, engage in the practice of law, and continue to receive retirement pay.<br>Tax Court judges who resign after meeting these age and longevity of tenure requirements, but who engage in the practice of Federal tax or contract law, forfeit retirement pay. Forfeiture also occurs if a retired (rather than resigned) judge accepts a government position, whether compensated or not. | (e) No provision. | (e) No provision. | (e) Permit Tax Court judges to resign, practice law, and continue to receive retirement pay in the same manner that District Court judges currently are permitted to do.<br>Provide that forfeiture of retired pay by a retired judge who accepts a government position only applies if the position is compensated.<br>*Effective date.*—Date of enactment. |
| **H. Tax Administration Provisions**<br>**1. Authority to rescind statutory notice of deficiency** | Once the IRS has issued a statutory notice of deficiency, the IRS does not have the authority to withdraw the notice; only a Tax Court decision can alter its effect. | No provision. | Where the IRS and the taxpayer mutually agree, a statutory notice of deficiency may be rescinded.<br>*Effective date.*—Statutory notices of deficiency issued on or after January 1, 1986. | Same as House bill.<br>*Effective date.*—Statutory notices of deficiency issued on or after date of enactment. |
| **2. Authority to abate interest due to errors or delay by the IRS** | The IRS does not have the authority to abate interest charges where the additional interest has been caused by IRS errors and delays, except in cases of certain IRS math errors. | No provision. | In cases where an IRS official fails either to perform a ministerial act in a timely manner or makes an error in performing a ministerial act, the IRS has the authority to abate the interest attributable to such delay. No aspect of the delay can be attributable to the taxpayer. The interest abatement only applies to the period of time attributable to the failure to perform the ministerial act, and only after the taxpayer has been contacted by the IRS.<br>The IRS is required to exercise this authority to abate interest in instances in which it issues an erroneous refund check, except where the taxpayer has caused the overstated refund to occur, or where an erroneous refund check exceeds $1 million.<br>*Effective date.*—Interest accruing with respect to deficiencies or payments for taxable years beginning in or after 1982. | Same as House bill, except that no significant aspect of the delay can be attributable to the taxpayer. |

## V. COMPLIANCE AND TAX ADMINISTRATION—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **3. Suspension of compounding where interest on deficiency is suspended** | The running of interest is suspended where the IRS fails to issue the taxpayer a bill stating how much the taxpayer owes within 30 days of concluding an audit. This rule does not apply to the compounding of interest on previously accrued interest. | No provision. | Compounded interest on the previously accrued interest is suspended when the underlying interest is also suspended.<br>*Effective date.*—Interest accruing in taxable periods after December 31, 1985. | Same as House bill.<br>*Effective date.*—Interest accruing after date of enactment and interest not paid as of date of enactment accruing after December 31, 1982. |
| **4. Exemption from levy for service-connected disability payments** | Various payments, such as unemployment benefits, workmen's compensation, and a minimum amount of ordinary wages, are exempt from IRS levy. Military service-connected disability payments are not, however, exempt from levy. | No provision. | Military service-connected disability payments are exempt from levy.<br>*Effective date.*—Payments made after December 31, 1985. | Same as House bill.<br>*Effective date*—Payments made after December 31, 1986. |
| **5. Modification of administrative rules applicable to forfeiture** | The IRS can seize property that is used in violating the provisions of the Internal Revenue laws. If the amount of personal property seized is valued at $2,500 or less, the IRS may use administrative procedures to forfeit the property and sell it without judicial action, after both appraisal and notice to potential claimants. | No provision. | The IRS may administratively sell up to $100,000 of personal property used in violation of the Internal Revenue laws. Such sale would require both an appraisal to determine value and notice to potential claimants. Potential claimants can require a court proceeding by posting a $2,500 bond.<br>*Effective date.*—January 1, 1986. | Same as present law. |
| **6. Certain recordkeeping requirements** | In general, law enforcement officers are not subject to the substantiation rules and the income and wage inclusion rules for specified use of a law enforcement vehicle. IRS special agents are not, however, included within the term "law enforcement officers." | No provision. | Use of an automobile by a special agent of the IRS is treated in the same manner as use of an automobile by an officer of any other law enforcement agency.<br>*Effective date.*—Date of enactment. | Same as present law. |

## V. COMPLIANCE AND TAX ADMINISTRATION—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| I. Modification of Employee Withholding Allowance Forms | Employees can claim withholding allowances on Form W-4. That form determines how much in Federal taxes is withheld from the employee's wages. Withholding allowances can be claimed for personal exemptions, tax credits, and estimated deductions (such as itemized deductions). That form remains in effect until the taxpayer changes or revokes it. | No provision. | Modify withholding schedules to better approximate the newly effective rate schedules.<br>*Effective date.*—January 1, 1986. | Same as House bill.<br>*Effective date.*—January 1, 1987. |
| J. Report on Return-Free Tax System | Individuals whose income exceeds specified levels must file income tax returns each year. Generally, these returns must be filed by April 15, unless the taxpayer receives an extension of time to file. | Provide the IRS with the authority to implement a return-free system for individuals. Taxpayers who meet certain criteria (relating to the complexity of their returns) would be offered the option of not filing an income tax return. Instead, the IRS would prepare the return and compute the tax liability of the taxpayer. The IRS would do this using wage reports currently filed with the Social Security Administration and information returns currently filed with the IRS. The IRS would send the taxpayer a report stating the Service's calculation of the taxpayer's tax liability. The taxpayer would be free to challenge the Service's calculation of tax.<br>*Effective date.*—Not specified in President's proposal. | Require a report from IRS to the House Ways and Means and Senate Finance Committees. Report would state:<br>(a) Who can participate in proposal and who cannot;<br>(b) How the proposal would be phased in;<br>(c) What resources (computers, staff, etc.) are needed; and<br>(d) The types of changes to the Code that would inhibit or enhance the use of the return-free system.<br>The IRS should also consider whether an in-house test of the proposal (not involving taxpayers) would be beneficial.<br>*Effective date.*—Report due in six months. | Same as House bill. |

BEST COPY AVAILABLE

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **K. Decrease Period of Tax Deferral for Trusts** | Beneficiaries of trusts are taxable on distributions from trusts to the extent of the trust's taxable income for taxable years ending with, or within, the taxable year of the beneficiary. If the trust is on a different taxable year than its beneficiaries, the beneficiaries defer taxable income from one taxable year to the next. A trust can elect to use any year as its taxable year. | No provision. | No provision. | Trusts (both existing and newly created) would be required to adopt a taxable year ending in October, November, or December.<br>In addition, trusts would be required to make estimated payments of their income taxes.<br>*Effective date.*—Taxable years ending after December 31, 1986. Therefore, the trust's first taxable year beginning after December 31, 1986, will be a short taxable year. Distributable net income taxable to beneficiaries for that short taxable year would be included in income of the beneficiary evenly over a 4-year period. |
| **L. Payment of Income Taxes of Estates** | Income tax of an estate is payable in four quarterly payments after the year in which the income is earned. | No provision. | No provision. | Estates would be required to make estimated payments of income taxes. Any remaining income taxes of an estate would be payable at the normal due date of the income tax return of the estate (i.e., 3½ months after the close of the taxable year).<br>*Effective date.*—Taxable years ending after the date of enactment. |

BEST COPY AVAILABLE

## VI. CORPORATE AND GENERAL BUSINESS TAXATION

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **A. In General** | | | | |
| **1. Corporate tax rates** | Corporate taxable income is subject to tax under a 5-bracket graduated rate structure as follows:<br>*Taxable Income* — *Rate*<br>$25,000 or less .......... 15<br>$25,000–$50,000 .......... 18<br>$50,000–$75,000 .......... 30<br>$75,000–$100,000 .......... 40<br>Over $100,000 .......... 46<br>An additional 5 percent tax is imposed on a corporation's taxable income in excess of $1 million, up to a total additional tax of $20,250. This results in elimination of the benefit of the graduated rate structure (in effect, payment of tax at a flat 46 percent rate) for income over $1,405,000. | Corporate income would be subject to tax under a 4-bracket graduated rate structure as follows:<br>*Taxable Income* — *Rate*<br>$25,000 or less .......... 15<br>$25,000–$50,000 .......... 18<br>$50,000–$75,000 .......... 25<br>Over $75,000 .......... 33<br>The graduated rates would be phased out for corporation with taxable income in excess of $140,000 by imposing an additional 5-percent tax on income between $140,000 and $345,000. Thus, corporations having taxable income of $345,000 or more would, in effect, pay tax at a flat 33 percent rate.<br>*Effective date.*—July 1, 1986 (income in taxable years that include July 1, 1986, would be subject to "blended" rates). | Corporate income would be subject to tax under a 3-bracket graduated rate structure as follows:<br>*Taxable income* — *Rate*<br>$50,000 or less .......... 15<br>$50,000-$75,000 .......... 25<br>Over $75,000 .......... 36<br>An additional 5-percent tax would be imposed on income between $100,000 and $365,000. Thus, corporations having taxable income of $365,000 or more would, in effect, pay tax at a flat 36 percent rate.<br>*Effective date.*—July 1, 1986 (income in taxable years that include July 1, 1986, would be subject to blended rates). | Same as House bill, except maximum corporate rate would be 35 percent. Thus, corporate income would be subject to tax under a 3-bracket graduated rate structure as follows:<br>*Taxable Income* — *Rate*<br>$50,000 or less .......... 15<br>$50,000–$75,000 .......... 25<br>Over $75,000 .......... 35<br>Under the phase-out, corporations having taxable income of $350,000 or more would, in effect, pay tax at a flat 35 percent rate.<br>*Effective date.*—July 1, 1987 (income in taxable years that include July 1, 1987, would be subject to blended rates). |
| **2. Corporate dividends paid deduction** | Corporations generally compute taxable income and are subject to a separate corporate-level tax without deduction for dividends paid to shareholders.<br>Foreign shareholders of U.S. corporations generally are subject to 30-percent withholding tax on dividends; a lower rate may be provided by treaty. Tax-exempt entities generally are not taxable on dividends received, except in certain cases where the tax-exempt entity owns debt-financed property. | Domestic corporations would receive a deduction for 10 percent of dividends paid out of corporate earnings that have been subject to tax after the general effective date. Additional compensatory withholding tax equal to the tax benefit received from the deduction would be imposed on foreign shareholders not protected by treaty. No special rules are provided for dividends paid to tax-exempt shareholders.<br>*Effective date.*—Generally, taxable years beginning after December 31, 1986, with special rule for dividends paid after that date in taxable years beginning before January 1, 1987. | Same as President's proposal except phased in over 10 years beginning in 1987; deduction would be 1 percent for taxable years beginning after January 1, 1987, increasing 1 percent each year up to 10 percent for taxable years beginning after January 1, 1996.<br>Also, President's proposal is modified as follows:<br>(a) The deductible portion of dividends paid to tax-exempt shareholders owning 5 percent or more of a corporation's stock would be treated as taxable "unrelated business income" to the shareholder.<br>(b) A compensatory withholding tax would be imposed on dividends paid after December 31, 1988, to foreign shareholders otherwise protected by treaty, except where the foreign country grants equivalent relief from a two-tier tax to U.S. shareholders. | Retain present law. |

## VI. CORPORATE AND GENERAL BUSINESS TAXATION—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **3. Corporate dividends received deduction** | Corporations generally are entitled to an 85 percent dividends received deduction; 100 percent dividends received deduction applies to dividends from certain affiliates.<br>Dividends received deduction is limited for dividends from a foreign corporation, based on extent of the foreign corporation's earnings subject to U.S. tax. No dividends received deduction for dividends on stock not held with substantial risk of loss for a specified period. Deduction is limited for dividends on certain "debt financed portfolio stock." | Dividends received deduction for corporations modified, so that a 90 percent dividends received deduction is available for dividends paid out of earnings that have been subject to corporate tax and a 100 percent dividends received deduction is available for dividends paid out of earnings that have not been subject to corporate tax. Extent of stock ownership would not matter.<br>*Effective date.*—Generally, taxable years beginning after December 31, 1986, with special rule for dividends paid after that date in taxable years beginning before January 1, 1987. | The 85 percent dividends received deduction would be reduced to 80 percent for dividends received after 1985, and then reduced over 10 years to 70 percent. The phase-in period corresponds to that of the dividends paid deduction.<br>Same as President's proposal for dividends eligible for the 100 percent dividends received deduction, except that the proposal is phased in corresponding to the phase-in of the payor's dividends paid deduction. | Same as present law, except the 85 percent dividends received deduction is reduced to 80 percent.<br>*Effective date.*—Dividends received after December 31, 1986. |
| **4. Dividend exclusions for individuals** | First $100 of qualifying dividends received by an individual ($200 by married couple filing joint return) is excluded from income.<br>Generally, qualifying dividends are dividends from domestic corporations. | Dividend exclusion for individuals would be repealed.<br>*Effective date.*—Taxable years beginning after December 31, 1985. | Same as President's proposal, with clarification that the exclusion is repealed for dividends *received* in taxable years beginning after December 31, 1985, regardless of when paid by the corporation. | Same as House bill.<br>*Effective date.*—Dividends received in taxable years begining after December 31, 1986. |
| **5. Stock redemption payments** | In general, a corporation may not deduct the cost of repurchasing its own stock from shareholders. Some corporations have taken the position that stock redemption payments and related expenses for the purpose of preventing a hostile takeover of the corporation (so-called "greenmail" payments) are deductible as ordinary business expenses. | No provision. | Provides that no portion of payments by a corporation in connection with a redemption of its own stock is deductible.<br>*Effective date.*—No effective date is expressly provided. | Same as House bill.<br>*Effective date.*—The provision would be effective for payments on or after March 1, 1986. |

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **6. Special limitations on net operating loss (NOL) carryovers** | | | | |
| *a. General approach* | (a) There is no consistent approach. If the limitations apply, NOL carryovers are reduced or eliminated, depending on whether the transaction takes the form of a tax-free reorganization or a taxable purchase, respectively. | (a) No provision. | (a) The new owners of a loss corporation would not be able to use a NOL carryover more rapidly than it would be used if there were no change in ownership. In general, if the limitations apply, the earnings against which an NOL carryover could be deducted—and not the NOL carryover itself—would be limited, with an exception for stock acquired by reason of death; transferee treated as having owned stock during the period held by a decedent who was a family member. | (a) Same as House bill, with exceptions for stock acquired by reason of death, gift, separation, or divorce; also, exceptions for acquisitions by ESOPs or ESOP participants. |
| *b. Taxable purchases* | | | | |
| *(1) When limitations apply* | (b)(1) The limitations apply if there is a purchase of 50 percent or more of the stock of a loss corporation, unless the business-continuation requirement described below is satisfied. | (b)(1) No provision. | (b)(1) The limitations would apply after change in ownership of more than 50 percent of the value of a loss corporation's equity. | (b)(1) The limitations apply after change in ownership of more than 50 percent of the value of a loss corporation's stock (with regulatory authority to treat other equity interests—such as warrants—as stock). |
| *(2) Effect of change of ownership* | (2) NOL carryovers are eliminated. | (2) No provision. | (2) The earnings available for offset in each post-acquisition year generally would be limited to an amount equal to the tax-exempt long-term bond rate multiplied by the loss corporation's equity value immediately before the ownership change (immediately after the ownership change after a redemption). | (2) The earnings available for offset would be limited to the Federal mid-term rate multiplied by the value of the loss corporation's stock immediately before the ownership change. |
| *(3) Period for testing ownership changes* | (3) Two years. | (3) No provision. | (3) Three years. | (3) Same as House bill, except—other than in cases where a loss corporation has a built-in loss that is subject to the special limitations—the testing period would not begin before the first taxable year from which there is a carryover. |
| *(4) Shareholders taken into account* | (4) Ten largest shareholders. | (4) No provision. | (4) All 5% or greater shareholders, with all less-than-5% shareholders treated as one 5% shareholder. | (4) All 5% or greater shareholders. |
| *(5) Constructive ownership rules* | (5) The constructive ownership rules of section 318 apply, so that a purchase from one whose stock would be attributed to the purchaser would be disregarded, except that the attribution rules for corporations and shareholders apply without regard to the 50-percent limitations in section 318. | (5) No provision. | (5) Same as present law, except a corporation would be treated as owning stock owned by a shareholder in the proportion that the value of the shareholder's stock in the corporation bears to the value of all outstanding stock, and stock underlying an option would be attributed to the person whose ownership would cause the limitations to apply. | (5) Same as House bill, except the 50-percent limitations in section 318 are replaced by 5-percent limitations, and the option attribution rules apply only to the extent provided in regulations. |
| *(6) Business continuation requirement* | (6) NOL carryovers are eliminated if the loss corporation fails to continue the conduct of a trade or business that was conducted before the change in ownership. | (6) No provision. | (6) NOL carryovers are eliminated unless the loss corporation satisfies the continuity of business enterprise requirement that applies to tax-free reorganizations (see c.3., below), during the two-year period following the acquisition. | (6) No provision. |

## VI. CORPORATE AND GENERAL BUSINESS TAXATION—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| *c. Tax-free reorganizations* | | | | |
| *(1) When limitations apply* | (c)(1) The limitations apply if the loss-corporation shareholder's continuing interest is less than 20 percent. | (c)(1) No provision. | (c)(1) Apply the same rule that applies to taxable purchases, except the rule for less-than-5% shareholders would not apply. | (c)(1) Same as House bill. |
| *(2) Effect of change of ownership* | (2) NOL carryovers are reduced by 5 percent for each 1 percent by which the continuing interest is below 20 percent. | (2) No provision. | (2) Apply the same rule that applies to taxable purchases. | (2) Same as House bill. |
| *(3) Business continuation requirement* | (3) No general requirement that business be continued, though in certain cases some continuity of business enterprise may be required for tax free reorganization treatment. | (3) No provision. | (3) Apply the same rule that applies to taxable purchases. | (3) Same as present law (*but see* item VI.A. 8. a., below, for modification of definition of a tax-free reorganization). |
| *d. Successive ownership changes* | (d) No provision. | (d) No provision. | (d) A rule is provided to prevent taxpayers from circumventing the special limitations by acquiring control of a loss corporation by means of a taxable transaction followed by a tax-free reorganization. | (d) Rules would be provided to prevent taxpayers from circumventing the special limitations by means of any combination of successive ownership changes (e.g., a tax-free reorganization followed by a taxable purchase). |
| *e. Built-in gains and losses* | (e) The special limitations do not apply to built-in gains and losses. | (e) No provision. | (e) For a 10-year recognition period, apply the special limitations to built-in losses (including built-in depreciation deductions), with relief for built-in gains, subject to a 15-percent de minimis rule. Provide that the value of assets cannot exceed the purchase price of a controlling stock interest, for purposes of determining whether there is a built-in loss. | (e) For a 5-year recognition period, apply the special limitations to built-in losses (but not built-in depreciation deductions), with relief for built-in gains, subject to a 25-percent de minimis rule. |

## VI. CORPORATE AND GENERAL BUSINESS TAXATION—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| *f. Bankruptcy proceeding and stock-for-debt exchanges* | (f) Stock received in exchange for an unsecured creditor's claim is not treated as a continuing stock interest under the rule for taxable purchases. Secured creditors who receive stock in certain exchanges are treated as continuing shareholders. NOLs are generally available without limitation following a bankruptcy reorganization. Special rules are provided for reorganizations described in section 368(a)(3)(D)(ii) (relating to financially troubled thrifts). | (f) No provision. | (f) After a bankruptcy reorganization or a stock-for-debt exchange that occurs as part of a bankruptcy proceeding, a loss corporation's equity value is measured immediately after the ownership change. | (f) The special limitations would not apply after a bankruptcy reorganization or a stock-for-debt exchange that occurs as part of bankruptcy proceeding, if debt was held for one year before filing of bankruptcy or arose in ordinary course of loss corporation's business. Interest deductions on converted debt are backed out of NOL carryovers if deducted during the three-year period preceding bankruptcy proceeding. On a second ownership change within two years, NOLs would be unavailable. |
| *g. Other tax attributes* | (g) Similar rules apply to the carryover of credits and capital losses. | (g) No provision. | (g) Similar rules would apply to credits and capital losses, except foreign tax credit carryovers would be limited pursuant to regulations. | (g) Same as House bill. |
| *h. Measurement of beneficial ownership* | (h) Ownership changes are measured by reference to all shares, except nonvoting stock, that is limited and preferred as to dividends. | (h) No provision. | (h) Ownership changes would be determined without regard to stock that does not represent an interest in a corporation's growth potential. | (h) Same as House bill. |
| *i. Passive assets* | (i) No specific rule, although, under the rule for taxable purchases, the loss corporation must hold assets used in a trade or business. | (i) No provision. | (i) If at least one-third of loss corporation's assets consist of passive assets, the income against which NOL carryovers could be used would be subject to reduction. | (i) No NOLs are available if two-thirds or more of loss corporation's asset value is attributable to assets held for investment (except if a RIC or a REIT). |
| *j. Capital contributions* | (j) No specific provision. | (j) No provision. | (j) The value of the loss corporation's equity would be reduced by the value of capital contributions made within 3 years of the acquisition date. | (j) The value of the loss corporation's stock would be reduced by capital contributions made with a tax-avoidance motive. Capital contributions made within two years of the acquisition date would be presumed to have a tax-avoidance motive. |
| *k. Tax-motivated transactions* | (k) Under section 269, NOL carryovers are subject to disallowance following acquisition of 50 percent of stock in a corporation or a tax-free acquisition of assets, if the principal purpose of the acquisition was tax avoidance. | (k) No provision. | (k) Retain present law. | (k) Retain present law. |
| *l. Effective date* |  | (l) No provision. | (l) *Effective date.*—The amendments are effective for acquisitions on or after January 1, 1986, and reorganizations pursuant to plans adopted on or after January 1, 1986, subject to general transitional rules for bankruptcy reorganizations and four special transitional rules. | (l) The new amendments would be effective for purchases after December 31, 1986 and reorganizations pursuant to plans adopted after December 31, 1986. |
| *m. Status of amendments made by Tax Reform Act of 1976* | (m) The 1976 Act amendments apply to purchases after December 31, 1985, and reorganizations pursuant to plans adopted on or after January 1, 1986. | (m) No provision. | (m) No provision. | (m) The amendments made by the 1976 Act would be repealed, effective January 1, 1986. |

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **7. Recognition of gain or loss on liquidating sales and distributions** | | | | |
| ***a. General rules*** | (a) In general, under the so-called *"General Utilities"* rule (the statutory codification of the result in a Supreme Court case), a corporation recognizes no gain or loss on a sale or distribution of its assets in liquidation.<br>Gain (but not loss) is generally recognized by a corporation on a nonliquidating distribution of property with respect to its stock (e.g., a dividend or redemption). The gain recognized is generally the excess of the fair market value of the property over its basis in the hands of the corporation. | (a) No provision. | (a) In general, gain or loss would be recognized by a corporation on a liquidating distribution of its assets, as if it had sold them at fair market value, and on liquidating sales. | (a) Same as House bill. |
| ***b. Exceptions to general rules*** | (b)(1) *Liquidating distributions and sales.*—On a liquidating distribution or sale, a corporation may recognize gain under the recapture provisions, the tax benefit doctrine, or other statutory or judicial rules, notwithstanding the general nonrecognition rule. | (b)(1) No provision. | (b)(1) *Liquidating distributions and sales.*—Nonrecognition would be permitted for the following transactions by a liquidating corporation:<br>(1) certain carryover basis distributions to controlling corporate shareholders;<br>(2) certain distributions in connection with tax-free transactions;<br>(3) certain distributions with respect to stock held by noncorporate, long-term shareholders holding 10 percent or more of the distributing corporation's stock (under rules similar to the rules applicable to nonliquidating distributions under present law); and<br>(4) certain liquidating sales of property, and sales of stock treated as asset sales under section 338, to the same extent nonrecognition would be available if the property had been distributed.<br>The recapture rules and other statutory and judicial rules of present law would continue to apply to these excepted transactions. | (b)(1) *Liquidating distributions and sales.*—Exceptions from recognition would be provided for the following types of distributions in liquidation:<br>(1) distributions to a corporation where the distributee takes a carryover basis in the property;<br>(2) distributions consisting of stock in a subsidiary and qualifying for tax-free receipt under section 355; and<br>(3) distributions consisting of stock in a subsidiary controlled by the distributing corporation during the 5-year period preceding the distribution.<br>Under certain circumstances, no gain would be recognized on liquidating sales of property where the purchaser takes a carryover basis (see discussion of "qualified acquisitions", 8., below).<br>Loss would not be recognized by a corporation on liquidating distributions to certain related parties. |
| | (2) *Nonliquidating distributions.*—A corporation may be entitled to nonrecognition on a nonliquidating distribution if it relates to "qualified stock." Qualified stock is stock held by a long-term, noncorporate shareholder owning 10 percent or more of the corporation's outstanding stock. | (2) No provision. | (2) *Nonliquidating distributions.*—In general, present law rules would continue to apply to nonliquidating distributions, except that the rules relating to the qualified stock exception would be conformed to the rules for liquidating distributions. | (2) *Nonliquidating distributions.*—The same exceptions as for liquidating distributions would apply to gains. No loss would be recognized on nonliquidating distributions. |

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| *c. Relief from shareholder-level tax* | (c)(*1*) A corporation is treated as an entity separate from its shareholders for tax purposes. Thus, corporate earnings are generally taxed twice, first to the corporation when realized and later to the shareholders when distributed. No credit is given to shareholders for taxes paid by the corporation on corporate-level income.<br>(*2*) In certain types of liquidations, no shareholder-level tax may be imposed. A shareholder may elect not to recognize gain on receipt of an in-kind liquidating distribution and take a substituted basis in the property received equal to the adjusted basis of his stock (sec. 333). Gain is recognized, however, to the extent of the shareholder's ratable share of the corporation's earnings and profits, and the excess of money and stock or securities received over such ratable share. | (c) No provision. | (c) No provision. | (c)(1) Although gain would generally be recognized at the corporate level, relief from the shareholder tax would be provided for certain liquidations and acquisitions where the corporation's value does not exceed $5 million. In such cases, a basis increase would be allowed to shareholders with respect to their stock. The adjustment, which could not exceed the shareholder's gain on his stock, would approximate the amount of corporate gain recognized on long-held capital assets.<br>Partial relief from the shareholder-level tax would be provided in the case of corporations having a value between $5 million and $10 million.<br>(2) A shareholder in a liquidating corporation could elect not to recognize gain on distributions and take a substituted basis in the assets received equal to the adjusted basis of his stock. Gain would be recognized, however, to the extent cash or marketable securities were received. |
| *d. Effective date* | | | (d) *Effective date.*—In general, applies to distributions and sales and exchanges occurring on or after November 20, 1985. Under transitional rules, distributions and sales made pursuant to a plan of liquidation adopted before that date would not be affected. Special rules apply in determining whether a plan was adopted before November 20 for this purpose. | (d) *Effective date.*—The provisions would apply to distributions and sales and exchanges on or after March 1, 1986. Transitional rules similar to those in the House bill would be provided. |
| *e. Other special rules*<br>*(1) Collapsible corporations and controlled foreign corporations* | (e)(1)(i) A shareholder who disposes of stock in a collapsible corporation in a transaction that would otherwise produce capital gain (e.g., liquidation of the corporation) must treat the gain as ordinary income (sec. 341). A collapsible corporation is one formed or availed of for the manufacture, construction, or production of property, or the purchase of certain ordinary income or section 1231 assets, with a view to converting what would be ordinary income into capital gain. | (e) (1) No provision. | (e) (1) No provision. | (e)(1)(i) The collapsible corporation provisions would generally be repealed. Appropriate anti-avoidance rules would be provided. |
| | (ii) If a 10-percent or more U.S. shareholder of a controlled foreign corporation realizes gain on the disposition of the stock of a controlled foreign corporation, the gain is ordinary to the extent of the shareholder's share of the earnings and profits of the corporation accumulated during the period it held the stock (sec. 1248). | | | (ii) In addition to general earnings and profits rules, a 10-percent or more U.S. shareholder in a controlled foreign corporation would also recognize ordinary gain on disposition of the stock if 70 percent or more of the corporation's assets (exclusive of those held for 3 years or more) would be ordinary income property in the hands of substantial shareholders.<br>*Effective date.*—Dispositions of stock and liquidations on or after January 1, 1988. |

### VI. CORPORATE AND GENERAL BUSINESS TAXATION—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| ***e. Other special rules (Cont.)***<br>*(2) Subchapter S corporations* | (2) A closely-held business operating in corporate form may elect to have business gains and losses taxed directly to or (within certain limits) deducted directly by its individual shareholders (secs. 1361–1379, subch. S of the Code). In order to prevent taxation of the same income more than once, a shareholder's basis in the stock is increased by his share of corporate income, and decreased by his share of corporate losses.<br>A corporate-level tax is imposed on certain capital gains realized within 3 years of a subchapter S election by an S corporation that was formerly a C corporation (sec. 1374). | (2) No provision. | (2) A rule is provided to prevent circumvention of the repeal of the *General Utilities* rule through conversion to an S corporation. If an S corporation that was formerly a C corporation liquidates before the close of the second taxable year following the year in which the subchapter S election took effect, the election would be terminated retroactively to the first taxable year for which it was effective.<br>*Effective date.*—November 20, 1985. | (2) In general, a shareholder of an S corporation would be denied an increase in stock basis with respect to 80 percent of the long-term capital gain and 65 percent of all other gain recognized by the corporation on the disposition of assets during the 5-year period following (i) the date the election takes effect, where a C corporation makes an S election, or (ii) the date of the qualified acquisition, where an S corporation makes a carryover basis acquisition of a C corporation.<br>This provision would not apply if the assets are long-held capital assets or the corporation has a value of $5 million or less. Partial relief would be available if the corporation's value is between $5 million and $10 million.<br>*Effective date.*—March 1, 1986. |

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **8. Modification of merger and acquisition rules** | | | | |
| ***a. In general*** | (a) Tax-free and taxable mergers and acquisitions of corporations are governed by different sets of rules. A transaction qualifies for tax-free treatment only if it falls within one of several statutorily-defined categories of "reorganization" and meets certain regulatory and judicial requirements (*e.g.*, business purpose, continuity of business enterprise). Reorganization status depends on the existence of a substantial continuing equity interest in the acquiring corporation by the acquired corporation's shareholders.<br>A purchase of a controlling interest in the corporation by another corporation may, at the election of the acquiring corporation, be treated as a sale and purchase of the assets of the acquired corporation (sec. 338). Statutory "consistency" rules prevent the acquiring corporation from obtaining a cost basis in some assets of the acquired corporation or members of its affiliated group and a carryover basis in others. | (a) No provision. | (a) No provision. | (a) Acquisitions by a corporation of a controlling stock interest in another corporation or of substantially all of the corporation's assets ("qualified acquisitions") would be eligible for elective tax treatment at the corporate level, as described below. Elective treatment would be available without regard to whether the shareholders of the acquired corporation maintain a continuing equity interest in the acquiring corporation. Consistency rules would generally apply on an entity-by-entity rather than on an affiliated group basis, with a special exception for goodwill.<br>The nonstatutory requirements applicable to reorganizations (business purpose, continuity of business enterprise, etc.) would not apply in determining whether a transaction is a qualified acquisition. |
| ***b. Treatment of acquired and acquiring corporations*** | (b) In a tax-free "reorganization," the corporations that are parties to the reorganization generally recognize no gain or loss on the transfer of assets, stock, or securities, and the asset basis and tax attributes (*e.g.*, NOL carryovers, excess credits) of the acquired corporation carry over. In a taxable acquisition, gain or loss is generally recognized by the acquired corporation (although a liquidating corporation may be eligible for relief from recognition under sec. 337, relating to sales pursuant to a plan of complete liquidation), and its tax attributes disappear. The acquiring corporation takes a cost basis in the assets or stock of the acquired corporation.<br>A corporate controlling shareholder may elect to treat an acquisition of stock in a subsidiary as if the subsidiary had sold its assets in a section 337 liquidation (sec. 338). | (b) No provision. | (b) No provision. | (b) In the case of a qualified acquisition, the acquiring corporation could elect to treat the transaction as a carryover basis acquisition or as a cost basis acquisition.<br>In a carryover basis acquisition, the acquired corporation would recognize no gain or loss and the acquiring corporation (or the acquired corporation, if it remained in existence) would take a carryover basis in the acquired corporation's assets. The acquired corporation's tax attributes would survive.<br>In a cost basis acquisition the acquired corporation would recognize gain or loss, the acquiring corporation would take a cost basis in the acquired corporation's assets, and the acquired corporation's tax attributes would disappear. |

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| ***c. Treatment of shareholders of acquired corporation*** | | | | |
| *(1) Relationship of shareholder-level consequences to consequences at corporate level* | (c)(i) In a tax-free reorganization, shareholders and security holders of the acquired corporation generally recognize no gain or loss on the exchange of stock or securities for stock or securities of the acquiring corporation. In a taxable acquisition, gain or loss is recognized by shareholders and security holders irrespective of whether the consideration received is stock or securities of the acquiring corporation or other property. | (c)(1) No provision. | (c)(1) No provision. | (c)(1) In a qualified acquisition, the shareholders of the acquired corporation would not recognize gain or loss with respect to any qualifying consideration—in general, stock or securities of the acquiring corporation—received. The shareholder level consequences would be independent of the treatment at the corporate level (*i.e.,* whether a cost basis or carryover basis election is made). |
| *(2) Significance of type of consideration received by other shareholders* | (2) The qualification of a transaction as a reorganization depends upon whether, in the aggregate, the shareholders of the acquired corporation receive sufficient stock in the acquiring corporation to satisfy the statutory continuity of interest requirement. Accordingly, a shareholder who receives only stock in the acquiring corporation may be fully taxable on any gain realized in the exchange. | (2) No provision. | (2) No provision. | (2) In a qualified acquisition, the treatment of a shareholder of the acquired corporation would not be affected by the type of consideration received by other shareholders, but would depend solely on the nature of the consideration received by such shareholder (see (3), below). |
| *(3) Treatment of nonqualifying consideration* | (3)(i) If a shareholder of the acquired corporation receives nonqualifying consideration ("boot") in a reorganization, gain is recognized to the extent of the value of the consideration, but not in excess of the realized gain. Boot includes cash or property other than stock or securities of the acquiring corporation. If securities are received having a principal amount in excess of the principal amount of securities surrendered in the exchange, the fair market value of such excess is treated as boot. | (3) No provision. | (3) No provision. | (3)(i) In a qualified acquisition, the acquiring corporation or its shareholders would generally recognize gain to the extent they receive nonqualifying consideration. Under a special exception, however, gain would not be recognized by a controlling corporate shareholder on receipt of boot if the acquisition is a cost basis acquisition, or the controlling corporate shareholder is liquidated within 1 year after the acquisition. |
| | (ii) In general, liabilities assumed by the acquiring corporation are treated as boot only if the principal purpose of the assumption was tax avoidance. | | | (ii) Liabilities assumed by the acquiring corporation would be treated as boot unless they (i) constitute purchase money indebtedness or (2) are assumed by the transferee incident to its acquisition, holding, or operation in the ordinary course of business of the property transferred. The tax avoidance test of present law would be repealed. |
| | (iii) Gain attributable to boot is ordinary income to the shareholder if the distribution has the effect of a dividend. It is unclear whether the acquired or the acquiring corporation is to be viewed as having made the distribution in making this determination. | | | (iii) If the receipt of the boot has the effect of a dividend, the amount of ordinary income recognized would be the lesser of (1) the amount of money or the fair market value of property received or (2) the shareholder's share of the combined earnings and profits of the acquired and acquiring corporation; income would not be limited to the gain realized on the shares. |

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| *c. Treatment of shareholders of acquired corporation (Cont.)* | | | | In determining dividend equivalency, the acquiring corporation would be viewed as having distributed the boot in redemption of its stock. |
| | (iv) Loss is not recognized on receipt of boot. | | | (iv) Loss would not be recognized on the receipt of boot unless a shareholder of the acquired corporation receives no stock in the acquiring corporation, or a security holder of the acquired corporation receives no stock or securities in the acquiring corporation. |
| *d. Related and conforming amendments to section 351 (transfers to controlled corporations)*<br>*(1) In general* | (d)(1) No gain or loss is recognized on the transfer of property to a corporation controlled by the transferor immediately after the exchange in exchange for stock or securities of the transferee (sec. 351). | (d)(1) No provision. | (d)(1) No provision. | (d)(1) In the case of a corporate transferor, the requirement that the transferor have control of the transferee corporation "immediately after the exchange" would be satisfied even though the transferee is (as part of an overall plan) acquired in a qualified acquisition immediately following the exchange. The assets transferred in the section 351 exchange must constitute an active business within the meaning of section (disregarding the 5-year operation requirement) to qualify for this treatment. |
| *(2) Definition of control* | (2) Control for purposes of section 351 and the reorganization provisions means ownership of stock possessing at least 80 percent of the voting power and at least 80 percent of the total number of shares of all other classes of stock. | (2) No provision. | (2) No provision. | (2) Control for purposes of section 351 (and for purposes of the qualified acquisitions provisions) would be conformed to the definition of affiliation contained in the consolidated return provisions. Thus, control would be defined as stock of a corporation representing at least 80 percent of the total voting power and having a value equal to at least 80 percent of the total value of the corporation's stock. |
| *(3) Receipt of nonqualifying consideration*<br>(i) Debt instruments of transferee | (3)(i) No gain or loss is recognized by a shareholder on receipt of "securities" of the controlled corporation in a section 351 exchange, irrespective of whether securities are surrendered. Gain is recognized by a shareholder on the receipt of other types of debt (e.g., short-term notes) of the corporation, and by a nonshareholder on the receipt of any form of debt. | (3)(i) No provision. | (3)(i) No provision. | (3)(i) Consistent with the treatment of debt received in connection with a qualified acquisition, securities of the transferee corporation received in a section 351 exchange would trigger recognition of gain to the extent their issue price exceeds the adjusted basis of the securities surrendered. |
| (ii) Assumption of transferor's liabilities | (ii) If liabilities of the transferor are assumed in a section 351 exchange, gain is not triggered unless the liabilities exceed the basis of the property transferred, or the purpose of the transaction is tax avoidance. In a reorganization, the excess of liabilities assumed over the basis of property transferred generally does not constitute boot. | (ii) No provision. | (ii) No provision. | (ii) Consistent with the treatment of liabilities assumed in connection with a qualified acquisition, liabilities assumed in a section 351 exchange would be treated as boot unless they (1) constitute purchase money indebtedness or (2) are assumed by the transferee incident to its acquisition, holding, or operation in the ordinary |

## VI. CORPORATE AND GENERAL BUSINESS TAXATION—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| *d. Related and Conforming Amendments (cont.)* | | | | course of business of the property transferred. This exception would not apply, however, to the extent liabilities exceed the basis of property transferred. The tax avoidance test of present law would be repealed. |
| *(4) Overlap with merger and acquisition provisions* | (4) The proper treatment of a transaction that qualifies as both a section 351 exchange and a reorganization is unclear. | (4) No provision. | (4) No provision. | (4) A transaction that qualifies as both a section 351 exchange and a qualified acquisition would generally be treated as a qualified acquisition. |
| *e. Effective date* | | | | (e) *Effective date.*—Transactions after December 31, 1987. |

BEST COPY AVAILABLE

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **9. Miscellaneous subchapter C changes**<br>***a. Transfers to controlled corporations (sec. 351)***<br>*(1) Installment sales between shareholders and a controlled corporation* | (a)(1) An installment sale between a corporation and its shareholders may not be subject to section 351. If the sale is not subject to section 351, the transferee may obtain a stepped-up (fair market value) basis although recognition of the transferor's gain is deferred under the installment method. | (a)(1) No provision. | (a)(1) No provision. | (a)(1) An installment sale of property to a corporation by a 20 percent or more shareholder would be treated as a section 351 exchange. The transferee's basis in the property would be increased only as and to the extent the transferor recognizes gain.<br>*Effective date.*—Transactions after December 31, 1987. |
| *(2) Basis of stock received in a section 351 exchange* | (2) The transferor's basis for stock or securities received in a section 351 exchange is generally the adjusted basis in the property transferred. If the property has a basis in excess of its fair market value, there would be a potential loss in the transferor's stock as well as in the property. Thus, the loss may be recognized twice. | (2) No provision. | (2) No provision. | (2) If the fair market value of property transferred in a section 351 exchange is less than its adjusted basis, the basis of the stock received would be the fair market value of the property.<br>*Effective date.*—Transactions after December 31, 1987. |
| ***b. Adjustments to basis of a controlling corporate shareholder in subsidiary stock*** | (b) The basis of a controlling corporate shareholder in the stock of a subsidiary corporation may be a cost, a carryover, or a substituted basis depending on the manner in which the stock was acquired. This basis may have no relation to the subsidiary's basis in its assets. Thus, the parent's potential "outside" gain or loss on the stock of the subsidiary and the subsidiary's "inside" gain or loss on its assets may be different, producing different results in an acquisition of the subsidiary depending on whether the stock or assets are sold.<br>Where a parent corporation and its subsidiary file a consolidated return, adjustments to stock basis required under Treasury regulations for post-acquisition earnings and losses, and intercompany transactions and distributions may lessen the disparity between inside and outside basis. | (b) No provision. | (b) No provision. | (b) If a corporation acquires a controlling interest in another corporation (other than in a cost basis acquisition, where "inside" and "outside" basis would otherwise be conformed), the controlling corporation's basis in the subsidiary's stock would generally be equal to its cost during the 3-year period following acquisition of control. Adjustments would be made for gains and losses accruing prior to acquisition of control but recognized by the subsidiary during this period.<br>Following the 3-year period, the parent's basis in the stock of the subsidiary would generally equal its allocable share of the subsidiary's basis in its assets, net of liabilities.<br>*Effective date.*—January 1, 1988. (The basis of controlling corporate shareholders in the stock of existing subsidiaries held as of this date would also be conformed to the subsidiaries' asset basis). |

## VI. CORPORATE AND GENERAL BUSINESS TAXATION—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **10. Extraordinary dividends received by corporate shareholders** | If a corporate shareholder receives an "extraordinary" dividend on stock and disposes of the stock without holding it for more than 1 year, the basis of the stock must be reduced by the amount of the untaxed portion of the dividend. "Extraordinary dividend" is defined in terms of the size of the dividend in relation to the shareholder's adjusted basis in its stock. The untaxed portion of the dividend is the excess of the value of the distribution over the taxable portion of the distribution (i.e., net of the dividends received deduction). | No provision. | No provision. | The basis of stock held by a corporation would be reduced by the untaxed portion of extraordinary dividends, regardless of the holding period of the stock.<br>*Effective date.*—Dividends declared after March 18, 1986. |
| **11. Ordinary income treatment on sales between related entities** | (a)(1) *General rule.*—Gain on a sale of property to a related party is treated as ordinary income if the property is depreciable in the hands of the transferee. Installment sale treatment is not available in such a case unless it is established to the satisfaction of the Internal Revenue Service that tax avoidance was not a principal purpose of the sale. | (a)(1) No provision. | (a)(1) No provision. | (a)(1) Same as present law. |
| | (2) Related parties for this purpose include a person and all entities which are 80 percent owned, directly or indirectly, with respect to that person. Specified attribution rules apply. | (2) No provision. | (2) No provision. | (2) Related parties would include a person and all entities more than 50 percent owned, directly or indirectly, with respect to that person. Related parties would also include entities more than 50 percent owned, directly or indirectly, by the same persons. Attribution and relationship rules would generally be based on present law rules that apply to limit losses on sales between related parties. For example, there would be attribution between parents and children. |
| | (b)(1) *Additional partnership rule.*—Gain on the sale of property between a partnership and certain related parties is ordinary income if the property is not a capital asset in the hands of the transferee. | (b)(1) No provision. | (b)(1) No provision. | (b)(1) Same as present law. |
| | (2) Related parties for this purpose include a partner and a partnership in which that person owns, directly of indirectly, more than 80 percent of the interests. Related parties also include partnerships in which the same persons own, directly or indirectly, more than 80 percent of the interests. Specified attribution rules apply, generally based on the rules that apply to limit losses on sales between related parties. | (2) No provision. | (2) No provision. | (2) Related parties would include a partner and a partnership in which that person owns, directly or indirectly, more than 50 percent of the interests. Related parties would also include partnerships in which the same persons own, directly or indirectly, more than 50 percent of the interests. Attribution would continue to be based on the present law rules that limit losses on sales between related parties.<br>(c) *Effective date.*—These changes in related party definitions and attribution rules would apply to sales after December 31, 1986. |

## VI. CORPORATE AND GENERAL BUSINESS TAXATION—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **12. Holding period requirement for dividends received deduction** | No deduction is allowed in respect of any dividend on any share of stock that is sold or otherwise disposed of before the corporate shareholder satisfies a 46-day holding period requirement. The 46-day period does not include any period during which the corporate shareholder reduces the risk of loss from holding the stock. | No provision. | The dividends received deduction is disallowed where the holding period requirement is not met, without regard to whether the stock has been disposed of.<br>*Effective date.*—Stock acquired after date of enactment of house-passed H.R. 3838. | Reduce basis of stock held by a corporation to the extent of dividends received deductions claimed with respect to dividends the exdividend date of which occurs within 45 days after the date of purchase. Disallow dividends received deduction for any dividends attributable to a period during which the taxpayer substantially diminished the risk of loss from holding the stock.<br>*Effective date.*—Stock acquired on or after March 1, 1986. |
| **13. Amortizable bond premium** | The holder of a bond acquired at a premium can elect to amortize the premium—taking ordinary deductions—over the term of the bond. Amortizable bond premium is defined to include any excess of a bond's basis over the amount payable at maturity. | No provision. | No provision. | Clarify that bond premium is created only where a bond's "issue price" (generally, the price paid or value of consideration used to acquire the bond) exceeds the amount payable at maturity.<br>*Effective date.*—Bonds acquired on or after March 19, 1986. |

BEST COPY AVAILABLE

## VI. CORPORATE AND GENERAL BUSINESS TAXATION—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **B. Rapid Amortization Provisions**<br>**1. Five-year amortization of trademark and trade name expenditures** | Taxpayers may elect to amortize over a period of at least 60 months expenditures for the acquisition, protection, expansion, registration, or defense of a trademark or trade name, other than an expenditure which is part of the consideration for an existing trademark or trade name. | The election would be repealed. Trademark and trade name expenditures would therefore generally be capitalized and recovered on a disposition of the asset. | Same as President's proposal. | Same as President's proposal. |
| | | *Effective date.*—The repeal would be effective for expenditures paid or incurred on or after January 1, 1986. | *Effective date.*—Expenditures paid or incurred on or after January 1, 1986. | *Effective date.*—Expenditures paid or incurred after December 31, 1986. |
| | | | *Transition rule.*—Present law applies to expenditures incurred:<br>(i) pursuant to a written contract that was binding as of September 25, 1985; or<br>(ii) with respect to development, protection, expansion, registration or defense commenced as of September 25, 1985, if the lesser of $1 million or 5 percent of cost has been incurred or committed by that date;<br>provided in each case the trademark or trade name is placed in service before January 1, 1988. | *Transition rule.*—Present law applies to expenditures incurred:<br>(i) pursuant to a written contract that was binding as of March 1, 1986; or<br>(ii) with respect to development, protection, expansion, registration or defense commenced as of March 1, 1986, if the lesser of $1 million or 5 percent of cost has been incurred or committed by that date,<br>provided in each case the trademark or tradename is placed in service before January 1, 1988. |
| **2. Five-year amortization of pollution control facilities** | Taxpayers may elect to amortize over a 60-month period the cost of a qualifying certified pollution control facility used in connection with a plant that was in operation before 1976. To the extent that a pollution control facility has a useful life in excess of 15 years, a portion of the facility's cost is not eligible for 60-month amortization, but must be recovered through depreciation | The election would be repealed. Expenditures for pollution control facilities would therefore be recovered in accordance with the applicable depreciation schedules. | Same as President's proposal. | Same as President's proposal. |
| | | *Effective date.*—The repeal would be effective for expenditures paid or incurred on or after January 1, 1986. | *Effective date.*—Expenditures paid or incurred on or after January 1, 1986. | *Effective date.*—Expenditures paid or incurred after December 31, 1986. |
| | | | *Transition rule.*—Present law applies to expenditures incurred:<br>(i) pursuant to a written contract that was binding as of September 25, 1985; or<br>(ii) with respect to facilities, construction of which is commenced as of September 25, 1985, if the lesser of $1 million or 5 percent of the cost has been incurred or committed by that date,<br>provided in each case the facility is placed in service before January 1, 1988. | *Transition rule.*—Present law applies to expenditures incurred:<br>(i) pursuant to written contract that was binding as of March 1, 1986, or;<br>(ii) with respect to facilities, construction of which is commenced as of March 1, 1986, if the lesser of $1 million or 5 percent of the cost has been incurred or committed by that date,<br>provided in each case the facility is placed in service before January 1, 1988. |

## VI. CORPORATE AND GENERAL BUSINESS TAXATION—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **3. Fifty-year amortization of qualified railroad grading and tunnel bores** | Domestic railroad common carriers may elect to amortize the cost of qualified railroad grading and tunnel bores over a 50 year period. "Qualified railroad grading and tunnel bores" include all land improvements (including tunneling) necessary to provide, construct, reconstruct, alter, protect, improve, replace, or restore a roadbed or right-of-way for railroad track. | The election would be repealed. Expenditures for railroad grading and tunnel bores would therefore be capitalized and recovered on disposition of the asset.<br>*Effective date.*—The repeal would be effective for expenses paid or incurred on or after January 1, 1986. | Same as President's proposal, except ACRS treatment is provided for certain railroad disaster.<br>*Effective date.*—Expenses paid or incurred on or after January 1, 1986.<br>*Transition rule.*—Present law would continue to apply to expenditures incurred:<br>(i) pursuant to a written contract that was binding as of September 25, 1985; or<br>(ii) with respect to construction, reconstruction, alteration, improvement, replacement or restoration commenced as of September 25, 1985, if the lesser of $1 million or 5 percent of cost has been incurred or committed by that date,<br>provided in each case the improvements are placed in service before Janaury 1, 1988. | Same as House bill.<br>*Effective date.*—Expenditures paid or incurred after December 31, 1986.<br>*Transition rule.*—Present law would continue to apply to expenditures incurred:<br>(i) pursuant to a written contract that was binding as of March 1, 1986; or<br>(ii) with respect to construction, reconstruction, alteration, improvement, replacement or restoration commenced as of March 1, 1986, if the lesser of $1 million or 5 percent of cost has been incurred or committed by that date,<br>provided in each case the improvements are placed in service before January 1, 1988. |
| **4. Deduction for loss in value of bus-operating authorities** | Generally, no deduction is allowed for a decline in value of property absent a sale or other disposition. The courts have denied a loss deduction where the value of an operating permit or license decreased as the result of legislation that expanded the number of permits or licenses issued, on the grounds that the permit or license continued to have value as a right to carry on a business. | No provision. | No provision. | Taxpayer would be allowed an ordinary deduction ratably over a 60-month period for the adjusted bases of bus operating authorities held on November 19, 1982, (the date of enactment of the Bus Regulatory Reform Act) or acquired after that date under a written contract that was binding on that date.<br>*Effective date.*—The provision would be effective retroactively for taxable years ending after November 18, 1982. |

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **C. Deductibility of Federal Excise Taxes and Tariffs** | Federal excise taxes are imposed on sale, use, importation, or manufacture of various products and services. Tariffs are imposed on importation of many products.<br>Excise taxes and tariffs are deductible for Federal income tax purposes when incurred in the conduct of a trade or business or for the production of income. Thus, in such cases the effective rate to the payor of these taxes and tariffs is less than the nominal rate.<br>Revenues from many of the excise taxes and certain tariffs are deposited in trust funds for user- or benefit-based spending programs. The amount transferred to such trust funds is equal to gross excise tax receipts. Thus, income tax deductions for such excise taxes and tariffs results in a net revenue loss to the general fund of the Treasury.<br>Excise taxes and tariffs are not deductible when incurred as personal expenses. | No provision. | No provision. | To ensure that the nominal and effective rates of Federal excise taxes and tariffs to the payors thereof would be the same, these taxes and tariffs would be nondeductible for income tax purposes.<br>An anti-avoidance rule would provide that all persons liable for payment of excise taxes would have taxable income (subject to the maximum corporate tax rate) in an amount no less than their excise tax liability. A similar rule would apply in the case of tariffs. Income tax credits could not be claimed against this income.<br>Technical and conforming amendments would be made clarifying the incidence of all excise taxes and tariffs. Persons liable for these taxes and tariffs, and therefore the person having income and incurring the nondeductible expense, would be the manufacturer, importer, or seller (or user in the absence of a sale) of a taxable product or the provider of taxable services.<br>*Effective date.*—Excise taxes and tariffs paid after December 31, 1986. |

## VI. CORPORATE AND GENERAL BUSINESS TAXATION—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **D. Other Capital-Related Costs** | | | | |
| **1. Merchant marine capital construction fund** | Taxpayers are entitled to deduct certain amounts deposited in a capital construction fund. Earnings from the investment or reinvestment of amounts in a capital construction fund are excluded from income.<br>A nonqualified withdrawal generates income to the taxpayer, subject to interest payable from the time the amount withdrawn was reported. | The rule providing special tax treatment for capital construction funds would be repealed.<br>*Effective date.*—No tax-free contributions to capital construction funds could be made after December 31, 1985, except with respect to vessels the taxpayer owned on January 1, 1986, or vessels with respect to which the taxpayer performs a substantial amount of construction or reconstruction before January 1, 1986. Amounts remaining in a capital construction fund on January 1, 1996, would be treated as withdrawn at that time. | The rules providing special tax treatment for capital construction funds are retained, but modified to coordinate the application of the Internal Revenue Code with the Merchant Marine Act: the maximum rate of tax is imposed on nonqualified withdrawals, the Secretaries of Transportation and Commerce are required to make reports to the Secretary of Treasury regarding monies in funds. A taxpayer whose fund balance exceeds appropriate program objectives is required to develop appropriate objectives within 3 years or treat the excess as a nonqualified withdrawal. A ten-year limit is imposed on the amount of time monies can remain in a fund; monies not withdrawn after a ten-year period are treated as nonqualified withdrawals according to a schedule, beginning with 20 percent in the 11th year and ending with 100 percent in the 15th year.<br>*Effective date.*—Taxable years beginning after December 31, 1985. | Same as House bill (with technical modifications to prevent the wasting of net operating loss and credit carryforwards), except there is no limitation on the amount of time monies can remain in a fund. For monies that remain in a fund for more than 15 years, a 50-percent excise tax is imposed on nonqualified withdrawals.<br>*Effective date.*—Taxable years beginning after December 31, 1986. |
| **2. Limitation on business tax credits** | The business tax credits earned by a taxpayer can be used to reduce up to 85 percent of tax liability in excess of $25,000. | No provision. | The limitation on the amount of income tax liability (in excess of $25,000) would be reduced from 85 percent to 75 percent.<br>*Effective date.*—Taxable years beginning after December 31, 1985. | Same as House bill.<br>*Effective date.*—Taxable years beginning after December 31, 1986. |
| **3. Contributions in aid of construction** | A regulated public utility that provides electric energy, gas, water or sewage disposal services may treat contributions received in aid of construction as nontaxable contributions to capital. | No provision. | The bill repeals the provision of present law allowing contributions in aid of construction to be treated as nontaxable contributions to capital.<br>*Effective date.*—Contributions received after December 31, 1985. | Same as House bill.<br>*Effective date.*—Contributions received after December 31, 1986. |

## VII. ENERGY, AGRICULTURE, TIMBER AND NATURAL RESOURCES

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **A. Agricultural Provisions** | | | | |
| **1. Special expensing provisions** | | | | |
| ***a. Soil and water conservation expenditures*** | (a) Certain expenditures incurred by farmers for soil and water conservation improvements may be expensed rather than capitalized. The deduction in each year may not exceed 25 percent of gross income derived from farming. | (a) Repealed.<br>*Effective date.*—Expenditures after December 31, 1985. | (a) Retain provision, but limit it to improvements consistent with USDA (or State) soil or water conservation plans. | (a) Same as House bill.<br>*Effective date.*—Expenditures after December 31, 1986. |
| ***b. Fertilizer and soil conditioning expenditures*** | (b) Certain expenditures incurred for fertilizer and soil conditioning may be expensed rather than capitalized. | (b) Repealed.<br>*Effective date.*—Expenditures after December 31, 1985. | (b) Same as President's proposal. | (b) Retain present law. |
| ***c. Land clearing expenditures*** | (c) Certain expenditures incurred by farmers for land clearing may be expensed rather than capitalized. The deduction in any year may not exceed the lesser of $5,000 or 25 percent of taxable income from farming. | (c) Repealed.<br>*Effective date.*—Expenditures after December 31, 1985. | (c) Same as President's proposal. | (c) Same as House bill.<br>*Effective date.*—Expenditures after December 31, 1986. |
| **2. Farming and ranching costs** | The Code and regulations provide exceptions from the otherwise applicable tax accounting rules for certain farmers and ranchers. For example, certain farmers and ranchers may elect to use the cash method of accounting when the accrual method would otherwise be required, and may use simplified inventory methods if an accrual method is adopted. | Farmers and ranchers would be subject to the uniform capitalization rules generally applicable to manufacturers and other producers of tangible property, including those relating to interest (see sec. III.D.). These rules would apply only if the preproductive period of the crop (the period prior to time the product reaches a productive stage) is 2 years or more.<br>*Effective date.*—Costs and interest incurred after December 31, 1985. | Same as President's proposal, except certain farmers would be given an election to deduct currently preproductive period costs. Taxpayers making this election, however, must recapture these costs on disposition of the product, and must use nonincentive depreciation on all farm assets.<br>*Effective date.*—Same as President's proposal. | Retain present law. |

## VII. ENERGY, AGRICULTURE, TIMBER AND NATURAL RESOURCES—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **3. Netting for cooperatives** | Cooperatives are permitted to exclude from their taxable income amounts distributed to patrons in the form of patronage dividends, and certain other amounts paid or allocated to patrons, to the extent of the net earnings of the cooperative from business done with or for patrons, provided that there is a pre-existing obligation to distribute such amounts.<br>Cooperatives that qualify as tax-exempt farmers' cooperatives also may exclude such amounts from income to the extent of all net income, and also may deduct to a limited extent dividends paid on common stock.<br>Under present law, the Code does not contain any explicit provision regarding whether a cooperative may "net" the earnings and losses of its various allocation units in computing its net earnings for the purposes of determining the amounts to be distributed or allocated to patrons.<br>The Code does not explicitly provide that a cooperative that so computes its net earnings may qualify as a tax-exempt farmers' cooperative. Nor does the Code require a cooperative to notify its patrons that it engages in the practice of "netting." | No provision. | Cooperatives (including tax-exempt farmers' cooperatives) would be permitted to offset patronage earnings and patronage losses (including losses carried to the taxable year) of their various allocation units in computing their net earnings.<br>Cooperatives that engage in the practice of netting earnings and losses would be required to notify their members that the amount of the member's distribution or allocation may have been affected by the cooperative's netting. The notice also would be required to specify the identity of the allocation units whose earnings and losses were offset, as well as what additional information the patron was entitled to under governing law.<br>*Effective date.*—The provisions relating to netting of patronage earnings and losses would be effective for taxable years beginning after December 31, 1962. The provisions relating to the notice requirement would be effective for taxable years beginning on or after the date of enactment. | Same as House bill. |

## VII. ENERGY, AGRICULTURE, TIMBER AND NATURAL RESOURCES—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **4. Treatment of certain plant variety protection certificates as patents** | A sale or exchange of all substantial rights to a patent by the individual whose efforts created the patent generally produces long-term capital gain. The Department of Agriculture administers a program pursuant to the Plant Variety Protection Act which extends protection to developers of sexually propagated plant varieties similar to those provided to patent holders. | No provision. | Provides that the term patent includes a plant variety protection certificate for purposes of the provision allowing capital gains treatment on certain dispositions of patents.<br>*Effective date.*—Dispositions after December 31, 1985. | Retain present law. |
| **5. Dispositions of converted wetlands and highly erodible croplands** | Gain from the sale of real property used in a trade or business and held for more than 6 months is taxed as capital gain if gains on all sales of section 1231 assets (real property and depreciable personal property used in a trade or business and held for more than 6 months) during the year exceed losses on such sales. If losses on section 1231 assets exceed gains, the net loss is an ordinary loss. | No provision. | Provides that gain on the disposition of converted wetland or highly erodible cropland will be treated as ordinary income, and any loss on the disposition of such property will be treated as a long-term capital loss.<br>*Effective date.*—Dispositions after December 31, 1985. | Same as House bill.<br>*Effective date.*—Dispositions of land converted on or after March 1, 1986. |
| **6. Prepayments** | Persons engaged in the trade or business of farming generally are permitted to use the cash method of accounting. However, farm syndicates are not allowed to deduct any amount paid for feed, seed or other supplies prior to the year in which such supplies are used or consumed. | No provision. | No provision. | Provide that farmers using the cash method of accounting could not deduct any amount paid for feed, seed, fertilizer or other supplies prior to the year in which such supplies are used or consumed if more than 50 percent of the expenses incurred in the trade or business are prepaid. Retain present law rule for farm syndicates.<br>*Effective date.*—Prepayments made on or after March 1, 1986. |

## VII. ENERGY, AGRICULTURE, TIMBER AND NATURAL RESOURCES—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **B. Timber and Ornamental Trees** | | | | |
| **1. Reforestation expenses** | Taxpayers may amortize over a 7-year period up to $10,000 of reforestation expenditures incurred in each taxable year.<br>A 10-percent tax credit is allowable for these expenditures. | Amortization over a 7-year period and the credit repealed for expenditures after December 31, 1985. | Same as President's proposal. | Retain present law. |
| **2. Expenses relating to the growing of timber and ornamental trees** | Most costs associated with the growing of timber and ornamental trees may be deducted in the year paid or incurred. | The comprehensive capitalization requirements for manufacturing and construction costs [see Item III. D.], including the capitalization of interest, would apply to timber and ornamental trees.<br>*Effective date.*—In general, costs and interest incurred after December 31, 1985. Growing costs attributable to timber planted before 1986 would be subject to capitalization under a 10-year phase-in rule (10 percent of such costs incurred in 1986 would have to be capitalized, 20 percent in 1987, etc.). | Same as President's proposal, except qualified small timber producers (taxpayers with 75,000 acres or less) may elect to amortize costs otherwise required to be capitalized as a result of the bill over a period of 5 years. The benefit of the election is phased out at a rate of 4 percent for each 1,000 acres (or part thereof) of timberland in excess of 50,000 acres. Taxpayers making the election are required to use non-incentive depreciation for assets used in the timber business which are placed in service while an election is in effect.<br>*Effective date.*—Same as President's proposal except that the capitalization of costs attributable to timber planted before 1986 would be phased in over a 5-year period. | Retain present law. |

## VII. ENERGY, AGRICULTURE, TIMBER AND NATURAL RESOURCES—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **C. Capital Gains for Coal, Iron Ore, and Timber** | | | | |
| **1. Capital gain treatment for coal and domestic iron ore royalties** | Royalties on dispositions of coal and domestic iron ore qualify for capital gain treatment, provided the coal or iron ore is held for more than six months before mining.<br>Capital gain treatment does not apply to (i) income realized as a co-adventurer, partner, or principal in the mining of coal or iron ore, or (ii) certain related party transactions.<br>If capital gain treatment applies, the royalty owner is not entitled to percentage depletion with respect to the same coal or iron ore. | Phase out capital gain treatment over a 3-year period beginning January 1, 1986.<br>*Effective date.*—For individuals, the exclusion rate on capital gains from coal and domestic iron ore royalties would be reduced to 30% in 1986, 20% in 1987, 10% in 1988, and 0 percent thereafter. For corporations, the tax rate on such capital gains would increase to 30% in 1986, 31% in 1987, 32% in 1988, and would be taxed at ordinary corporate rates thereafter. | Same as President's proposal. | Retain present law. |
| **2. Capital gain rules applicable to timber** | Timber royalty income qualifies for capital gain treatment, where the timber is held for 6 months before being cut.<br>Owners of timber (or a right to cut timber) may elect to treat the cutting of timber as a sale or exchange qualifying for capital gains treatment. To qualify, the timber (or contract cutting right) must be held for 6 months prior to cutting. | Phase out capital gains treatment over a 3-year period beginning January 1, 1986.<br>*Effective date.*—For individuals, the exclusion rate on capital gains from timber would be reduced to 30% in 1986, 20% in 1987, 10% in 1988 and 0 percent thereafter. For corporations, the tax rate would increase to 30% in 1986, 31% in 1987, 32% in 1988, and such gains would be taxed at ordinary corporate rates thereafter. | (a) Repeals capital gain treatment for timber on Federal lands, effective January 1, 1986.<br>(b) Repeals capital gain treatment for any ornamental tree, effective January 1, 1986.<br>(c) Phases out the capital gain treatment for corporations over a 3-year period beginning January 1, 1986. | Retain present law. |

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **D. Hard Minerals**<br>**1. Exploration and development costs**<br>***a. General rule*** | (a) Exploration and development costs associated with mines and other hard mineral deposits may be deducted currently at the election of the taxpayer. Exploration (but not development) costs which have been deducted currently either (1) are applied to reduce depletion deductions, or (2) at the taxpayer's election, are recaptured in income once the mine begins production, and then recovered as a depletable expense.<br>In the case of corporations, only 80% of hard mineral exploration and development costs may be expensed. The remaining 20% must be recovered over the 5-year ACRS depreciation schedule (beginning in the year that exploration and development costs are paid or incurred), with an investment tax credit for domestic costs. | (a) Retain present law. | (a) Same as President's proposal, but require recapture of both expensed development and exploration costs at the time the mine begins production. Recaptured amounts, and development costs incurred after the mine begins production, would be recovered in the same manner as depreciable property in Class 1 (3-year recovery period).<br>The 20 percent of corporate exploration and development costs that are not expensed would be recovered in the same manner as depreciable property in Class 2 (5-year recovery period), beginning in the year that costs are paid or incurred.<br>*Effective date.*—Costs paid or incurred after 1985. | (a) Retain present law. |
| ***b. Foreign exploration costs*** | (b) Foreign exploration costs must be capitalized to the extent the taxpayer's foreign and domestic exploration costs exceed $400,000 per year. | (b) Retain present law. | (b) Foreign exploration and development costs would be recovered.<br>(i) over a 10-year, straight-line amortization schedule, or<br>(ii) at the election of the taxpayer, as part of the basis for cost depletion.<br>*Effective date.*—Cost paid or incurred after 1985. | (b) Same as House bill.<br>*Effective date.*—Costs paid or incurred after 1986. |
| **2. Depletion of hard mineral deposits** | Depletable costs with respect to hard mineral deposits must be recovered using the greater of—<br>(i) cost depletion, or<br>(ii) percentage depletion at the applicable statutory rate for the mineral.<br>Percentage depletion may not exceed 50% of net income from the property in any taxable year.<br>For corporations only, percentage depletion of coal or iron ore, in excess of adjusted basis (determined without regard to the depletion deduction for that year), is reduced by 15 percent. | Phase out percentage depletion of hard minerals ratably over a 5-year period.<br>The basis for cost depletion of hard minerals would be indexed for inflation.<br>*Effective date.*—Production on or after January 1, 1986. | With the exceptions below, minerals whose present law depletion rate exceeds 5 percent are phased down ratably to 5 percent in 1988. Minerals having a 5-percent present-law rate (e.g., sand, gravel, and certain clay) are phased down ratably to 0. In conjunction with these changes, the 50 percent of net income limitation is phased down ratably to 25 percent.<br>Present law depletion rates are retained for<br>(i) minerals used to produce fertilizer or animal feed ("agricultural minerals"), and<br>(ii) dimension stone.<br>The 50 percent of net income limitation is retained for these substances. | Retain present law. |

## VII. ENERGY, AGRICULTURE, TIMBER AND NATURAL RESOURCES—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **2. Depletion of hard minerals (cont.)** | | | The 15-percent reduction in corporate coal and iron ore percentage depletion, in excess of adjusted basis, is retained.<br>Cost depletion would not be indexed for inflation.<br>*Effective date.*—Production after 1985. | |
| **3. Mining and solid waste reclamation costs** | Taxpayers may elect a special reserve method for deducting qualified mine and waste disposal reclamation and closing costs prior to economic performance. Taxpayers who do not elect this method are subject to the general rules of the Code that do not permit accrual-basis taxpayers to deduct expenses prior to the time when economic performance occurs. | The special reserve method for mine and waste disposal reclamation and closing costs would be repealed. Thus, such costs generally would be deductible only as the sites are closed or the land reclaimed (i.e., when economic performance occurs).<br>*Effective date.*—The proposal would be effective for mining or production activity on or after January 1, 1986. The Administration proposal does not indicate whether elections made before 1986 would be revoked. | Retain present law. | Retain present law. |
| **4. Gain on disposition of interest in mining property** | Adjusted exploration expenditures are recaptured as ordinary income. | All gain would be treated as ordinary income. | Expensed exploration and development expenses and depletion would be recaptured as ordinary income.<br>*Effective date.*—Dispositions of property placed in service after December 31, 1985 (unless acquired pursuant to a contract entered into on or before September 25, 1985). | Retain present law. |

## VII. ENERGY, AGRICULTURE, TIMBER AND NATURAL RESOURCES—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **E. Oil and Gas**<br>**1. Intangible drilling costs**<br>***a. General rule*** | (a) Intangible drilling and development costs (IDCs) generally may be expensed or capitalized at the election of the operator of an oil, gas, or geothermal property.<br>In the case of integrated producers, 80% of IDCs may be deducted currently and the remaining 20% must be amortized over a 36-month period beginning with the month the costs are paid or incurred.<br>Costs with respect to a nonproductive well ("dry hole") may be deducted currently by any taxpayer in the year the dry hole is completed. | (a) Retain present law. | (a) Retains present law with respect to domestic IDCs incurred prior to commencement of the installation of the production string of casing ("casing point").<br>IDCs incurred at, or subsequent to, the casing point are to be amortized over a 26-month period, beginning in the month paid on incurred. (Equivalent rules would apply to offshore wells.) These costs are not subject to the 20 percent reduction for integrated producers.<br>As under present law, unrecovered IDCs with respect to a dry hole could be deducted in the year the dry hole is completed.<br>*Effective date.*—Costs paid or incurred after 1985. | (a) Retain present law. |
| ***b. Treatment of foreign IDCs*** | (b) IDCs qualify for expensing whether incurred in the United States or in a foreign country. | (b) Retain present law. | (b) IDCs incurred outside of the United States are recovered,<br>(i) over a 10-year, straight-line amortization schedule, or<br>(ii) at the election of the operator, as part of the basis for cost depletion.<br>*Effective date.*—Costs paid or incurred after 1985. | (b) Same as House bill.<br>*Effective date.*—Costs paid or incurred after 1986. |

## VII. ENERGY, AGRICULTURE, TIMBER AND NATURAL RESOURCES—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **2. Depletion for oil and gas**<br>***a. General rule*** | (a) Depletable costs with respect to oil and gas properties must be recovered using whichever of two methods provides the higher deduction: cost depletion or percentage depletion.<br>Under cost depletion, the fraction of depletable costs recovered is equal to the ratio of hydrocarbons produced during the taxable year to total remaining reserves.<br>Under percentage depletion, 15% of the taxpayer's gross income is allowed as a deduction in any taxable year, not to exceed (i) 50% of net income from the property, or (ii) 65% of overall taxable income.<br>Percentage depletion for oil and gas properties is limited to independent producers and royalty owners for up to 1,000 barrels of daily production.<br>Geothermal properties are treated similarly to oil and gas wells, but are not subject to the 65% or 1,000 barrel per day rules. | (a) Phase out percentage depletion for most oil, gas, and geothermal properties over a 5-year period, by reducing depletion rate 3 percentage points in each year. Percentage depletion would be retained for oil and gas stripper wells owned by independent producers, but would not be available to royalty owners.<br>The basis for cost depletion would be indexed for inflation.<br>*Effective date.*—Production after 1985. | (a) Same as President's proposal, except—<br>(1) The phase-out period is 3 years instead of 5 years (5 percentage point reduction in each of years 1986, 1987, 1988),<br>(2) The stripper well exemption is extended to royalty owners, and<br>(3) No indexing of the cost depletion basis. | (a) Retain present law. |
| ***b. Treatment of bonuses and advance royalties*** | (b) Under a 1984 Supreme Court decision, percentage depletion is available with respect to oil and gas lease bonus or advance royalty payments. | (b) No provision. | (b) Denies percentage depletion for lease bonus, advance royalty, or other payments made without regard to actual production from an oil, gas, or geothermal property.<br>*Effective date.*—January 1, 1986. | (b) Retain present law. |
| **3. Gain on disposition of interest in oil, gas or geothermal property** | Expensed intangible drilling costs incurred after 1975 are recaptured as ordinary income to the extent of the excess of such costs over the amount that would have been deducted if the costs had been capitalized and deducted through depletion. | All gain would be treated as ordinary income. | Expensed intangible drilling costs and depletion would be recaptured as ordinary income.<br>*Effective date.*—Dispositions of property placed in service after December 31, 1985 (unless acquired pursuant to a contract entered into on or before September 25, 1985). | Retain present law. |

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **F. Energy-Related Tax Credits and Other Incentives** | | | | |
| **1. Residential energy tax credits** | | | | |
| ***a. Energy conservation items and insulation credit*** | (a) A 15-percent tax credit is allowed on the first $2,000 spent through 1985 for installations in a taxpayer's principal residence ($300 maximum credit) of items to reduce heat loss or gain, increase heating system efficiency, or reduce fuel consumption. Unused credits may be carried over through 1987. | (a) Allows the credit to expire as under present law. | (a) Same as President's proposal. | (a) Same as President's proposal. |
| ***b. Renewable energy credit*** | (b) A 40-percent tax credit is allowed on the first $10,000 spent through 1985 for renewable energy property, i.e., solar, wind and geothermal ($4,000 maximum credit). Unused credits may be carried over through 1987. Eligible equipment and parts include those necessary to transmit or use geothermal energy. | (b) Allows the credit to expire as under present law. | (b) Same as President's proposal, except that the solar energy tax credit would be extended for three years at reduced credit rates—30% in 1986 and 20% in 1987 and 1988. Expenditures for solar hot water property would be limited to $5,000. The credit could not be used to create a sun room, greenhouse, or similar structure. | (b)(1) Extend solar and geothermal energy credits at 30% credit rate in 1986 and 20% in 1987-1995. Other requirements are the same as the House bill.<br>(2) Extend wind energy credits at 10% credit rate in 1986 and at 5% credit rate in 1987-1995. |
| **2. Business energy tax credits** | | | | |
| ***a. Credit allowed*** | (a) The business energy tax credits are available in addition to the investment tax credit.<br>*Solar, wind, geothermal and ocean thermal property:*<br>15-percent credit through 1985.<br>*Intercity buses and biomass property:*<br>10-percent credit through 1985.<br>*Small-scale hydroelectric projects:*<br>11-percent credit through 1985, or 1988 if application docketed by FERC before 1986. | (a) Allow the credit to expire as under present law. | (a) Same as President's proposal, except that business solar and geothermal energy tax credits would be extended for three years at reduced credit rates: solar credits would be 15% in 1986, 12% in 1987, and 8% in 1988; geothermal credits would be 15% in 1986 and 10% in 1987 and 1988. | (a)(1) Extend solar and geothermal energy credits at 15% in 1986 and 1987 and at 10% in 1988-1995.<br>(2) Extend ocean thermal and biomass credits at a 10% credit rate in 1986 and 1987 and at 5% in 1988-1995.<br>(3) Extend wind energy credit rates at 10% in 1986 and at 5% in 1987-1995. |
| ***b. Unused credits*** | (b) Unused energy tax credits may be carried back 3 years and carried forward 15 years. | (b) Retain present law carryover of unused credits. | (b) Same as President's proposal. | (b) Same as President's proposal. |
| ***c. Affirmative commitment rules*** | (c) The expired 10-percent credit for alternative, etc., energy property continues to be available for long-term projects which meet rules requiring completion of engineering studies and application for all required permits before 1983, entering into binding contracts for 50% of special project equipment before 1986, and project completion before 1991. | (c) Retain present law affirmative commitment rules (including hydroelectric). | (c) Spread credit allowable each year over 5 years, i.e., 20 percent of the credit allowed for any years would be taken in each of 5 years. | (c) Retain present law. |

## VII. ENERGY, AGRICULTURE, TIMBER AND NATURAL RESOURCES—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **3. Credit for fuels from nonconventional sources** | A tax credit is provided for the domestic production and sale of specific fuels from nonconventional sources. The credit applies to eligible fuels sold after December 31, 1979, and before January 1, 2001, produced from:<br>(1) facilities placed in service after December 31, 1979, and before January 1, 1990, or<br>(2) wells drilled after December 31, 1979, and before January 1, 1990, on properties which first began production after December 31, 1979. | The credit generally would terminate after December 31, 1985.<br>Under a transitional provision, the credit would continue to be available for qualifying fuel which is produced from a well drilled, or facility completed, before January 1, 1986, and which is sold before January 1, 1990. | Same as President's proposal, except that an exception would be made for methane gas produced from wood in facilities placed in service before January 1, 1989, and sold before January 1, 2001. | Retain present law. |
| **4. Alcohol fuels credit and tax exemptions; import duty** | | | | |
| ***a. Alcohol fuels income tax credit*** | (a) A 60-cents-per-gallon credit is allowed for alcohol mixed with gasoline, diesel fuel, or any special motor fuel, if the mixture is sold or used as fuel. The credit also is provided for alcohol used in a trade or business or sold at retail and placed in a vehicle fuel tank. Eligible alcohol includes ethanol and methanol but not if made from petroleum, natural gas, or coal (including peat), or alcohol less than 150 proof. | (a) After December 31, 1985, the alcohol fuels tax credit would be available only for alcohol fuels produced from facilities completed before January 1, 1986, and sold before Jaunary 1, 1993. | (a) The 60-cents-per-gallon income tax credit would be repealed after December 31, 1985. | (a) Same as House bill, except effective after December 31, 1986. |
| ***b. Excise tax exemptions*** | (b)(1) *Alcohol fuels mixtures.*—A 6-cents-per-gallon exemption from excise taxes on gasoline, diesel fuel, and special motor fuels is provided for these fuels if they are mixed with at least 10 percent alcohol. Eligible alcohol may not be derived from petroleum, natural gas, or coal. | (b)(1) Repeal excise tax exemptions after 1985. | (b)(1) Present law would be retained. | (b)(1) Same as House bill. |
| | (2) *Alcohol fuels.*—A 9-cents-per-gallon exemption from the excise tax on special motor fuels is provided for neat methanol and ethanol fuels which are not derived from petroleum or natural gas. A 4½ cents exemption is provided if the fuels are derived from natural gas. Neat alcohol fuels are at least 85 percent methanol, ethanol, and other alcohol. | (2) Repeal excise tax exemptions after 1985. | (2) The 9-cents-per-gallon exemption would be reduced to 6-cents-per-gallon, effective after December 31, 1985. | (2) Same as House bill, except effective after December 31, 1986. |
| ***c. Duty on imported alcohol fuels*** | (c) A 60-cents-per-gallon duty is imposed on alcohol imported into the United States for use as a fuel.<br>The above provisions ((a), (b), and (c)) are scheduled to expire after December 31, 1992. | (c) Retain duty on alcohol imported for use as a fuel. | (c) Same as President's proposal. | (c) Same as President's proposal, with modification, effective after Dec. 31, 1986, that would deny duty-free treatment to ethyl alcohol imported from a CBI country, if in that country the ethyl alcohol has been only distilled, dehydrated, denatured, or blended with other ethyl alcohol. The modification would not apply to certain facilities established in reliance on a ruling issued by the U.S. Customs Service to the producer, provided that the ruling was issued prior to March 1, 1986. |

**VII. ENERGY, AGRICULTURE, TIMBER AND NATURAL RESOURCES—(Continued)**

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **G. Gift and Estate Tax Deductions for Certain Conservation Easement Donations** | Charitable contributions of qualified conservation easements in perpetuity to public charities or governmental entities are deductible for income, gift, and estate tax purposes if made exclusively for conservation purposes. If an irrevocable contribution of an easement fails to qualify for an income tax deduction because the conservation-purpose requirement is held not to be satisfied, the donor is subject to gift tax on the transfer. | No provision. | No provision. | An irrevocable charitable contribution in perpetuity of an easement in real property to a public charity or governmental entity, that otherwise would be deductible as a qualified conservation contribution, would not be nondeductible for gift or estate tax purposes solely for failure to satisfy the conservation-purpose requirement (sec. 170(h)(4)(A)). This rule would not allow an income tax deduction for the contribution.<br>*Effective date.*—Contributions made after December 31, 1986. |

## VIII. EXCISE AND EMPLOYMENT TAXES

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **A. Excise Taxes** | | | | |
| **1. Increase in wine tax rates to beer tax equivalent rate** | Wine is taxed at different rates depending on the alcoholic content of each type of wine. Beer is subject to tax at a rate of $9 per barrel. Wine containing 21% or less alcohol is subject to tax at a lower rate than beer on a proof basis. | No provision. | No provision. | The tax rate on wine having an alcohol content of 21% or less would be increased to a rate equivalent to the proof rate presently imposed on beer.<br>*Effective date.*—October 1, 1986. |
| **2. Adjust alcohol, tobacco, and fuel excise tax rates to reflect increases in prices** | Excise taxes on alcohol and tobacco products, on gasoline, diesel fuel, and special motor fuels, and on aviation fuels are imposed at flat rates per quantity of the taxable product rather than in a manner that reflects prices of the products. | No provision. | No provision. | The rates of excise taxes on alcohol and tobacco products and fuels would be adjusted to reflect changes in prices, but would not fall below the present-law levels.<br>*Effective date.*—October 1, 1986. |
| **3. Collection of diesel fuel excise tax** | An excise tax of 15 cents per gallon is imposed on the sale of diesel fuel for use in a diesel-powered highway vehicle. This tax is collected at the retail level.<br>The excise tax on gasoline (9 cents per gallon) is imposed and collected at the manufacturer's level. | No provision. | The diesel fuel excise tax for highway vehicles may be imposed on the sale from the wholesaler to the retailer of the fuel (or by the manufacturer where the sale is direct to the retailer), at the election of a "qualified retailer".<br>*Effective date.*—Sales of diesel fuel (for use in highway vehicles) after the first calendar quarter beginning more than 60 days after date of enactment. | No provision. |
| **4. Taxicab fuels tax exemption** | A 4-cents-per-gallon partial exemption from the motor fuels taxes (9 cents for gasoline and special motor fuels and 15 cents for diesel fuel) was provided for fuels used in qualifying taxicabs (through Sept. 30, 1985). The exemption was effectuated through a credit or refund (without interest). | No provision. | The 4-cents-per-gallon motor fuels tax exemption for taxicabs is extended for the period from October 1, 1985, through September 30, 1988 (the current expiration date for all Highway Trust Fund excise taxes). | Retain present law. |
| **5. Windfall profit tax exemption for certain exchanges of crude oil** | An excise tax (the crude oil windfall profit tax) is imposed on domestic crude oil when it is removed from the production premises. The tax does not apply if crude oil is used to power production equipment on the same property. | No provision. | An exemption is provided for certain otherwise taxable crude oil which is exchanged for an equal amount of residual fuel oil, to be used in enhanced recovery processes on the producing property. Only crude oil attributable to an operating mineral interest qualifies for the exception.<br>No depletion deduction (including cost or percentage depletion) is allowed with respect to crude oil qualifying for the exception.<br>*Effective date.*—Residual fuel oil used, and crude oil removed, after the date of enactment. | Retain present law. |

### VIII. EXCISE AND EMPLOYMENT TAXES—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **B. Employment Taxes**<br>**1. Exemption from social security coverage for retired Federal judges on active duty** | The 1983 Social Security Amendments (P.L. 98-21) provided that the wages of all active Federal judges are subject to social security taxes, beginning January 1, 1984; this provision applied to both current and future judges. The 1983 law also provided that amounts received by judges who achieve senior (retired) status but who continue on active duty are subject to social security taxes on any part of their pay attributable to periods when they are performing judicial services. Those earnings also cause reductions in the judges' benefits under the social security retirement test. P.L. 98-118 delayed the effective date of this provision until January 1, 1986. | No provision. | No provision. | An exclusion would be provided from the definition of wages for social security purposes for amounts received by Federal judges who meet the criteria for retirement on salary (e.g., age 65 with 15 years of service or 70 with 10 years of service), who retire, and who perform active duty. The effect of this exclusion would be to exempt such amounts from social security taxes and to preclude such amounts from being counted for social security earnings test purposes.<br>*Effective date.*—Services performed after December 31, 1983. |
| **2. FUTA tax provisions**<br>***a. Certain nonresident farm workers*** | (a) An exemption from FUTA was provided for wages paid for agricultural labor performed by aliens admitted to the United States pursuant to sections 214(c) and 101(a)(15)(H) of the Immigration and Nationality Act (Code sec. 3306(c)(1)(B)). This exemption expired on December 31, 1985. | (a) No provision. | (a) No provision. | (a) The FUTA exemption for certain nonresident farm workers would be reinstated and extended, for wages paid after December 31, 1985 and before January 1, 1988. |
| ***b. Summer camp counselors*** | (b) A one-year exemption from FUTA was provided for wages paid for 1983 by certain summer camps for employees who were full-time students (sec. 276(b) of P.L. 97-248). | (b) No provision. | (b) No provision. | (b) A permanent FUTA exemption would be provided for wages paid to summer camp counselors who are full-time students, effective for wages paid after September 19, 1985. |
| ***c. Fishing boat crew members*** | (c) An exemption from FUTA was allowed for remuneration paid during 1981-84 to certain fishing boat crew members. This exemption applied only if the remuneration depended on the boat's catch and the crew normally consisted of fewer than 10 members (sec. 822(b) of P.L. 97-34). | (c) No provision. | (c) No provision. | (c) A permanent FUTA exemption would be provided for wages paid to certain fishing boat crew members, effective for wages paid after December 31, 1980. |
| ***d. Agricultural wages*** | (d) FUTA tax applies to wages of agricultural workers on farms with a quarterly payroll of at least $20,000 with 10 or more employees in 20 weeks of the year. | (d) No provision. | (d) No provision. | (d) The quarterly payroll threshold at which agricultural wages are covered under FUTA would be increased from $20,000 to $40,000, effective for wages paid after September 30, 1986. |

## IX. FINANCIAL INSTITUTIONS

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **A. Reserves for Bad Debts** | | | | |
| **1. Commercial banks** | Commercial banks are allowed to deduct loan losses prior to the time that loans become wholly or partially worthless using either of two reserve methods: (1) the experience method, and (2) the percentage of eligible loans method. The availability of the percentage of eligible loans method is scheduled to expire for taxable years beginning after 1987.<br>If the bad debt deduction computed under the percentage of eligible loans method exceeds the deduction that would have been allowed under the experience method, then the deduction is reduced by 20 percent of such excess. | The use of both the experience and percentage of eligible loans methods would be repealed. Deductions for bad debts would be allowed when the loans are partially or wholly worthless (i.e., the "specific charge-off" method).<br>*Effective date.*—Taxable years beginning after 1985. The existing balance in the reserve for bad debts as of the effective date would be included in income ratably over a 10-year period, starting with the first taxable year beginning after 1985. Banks could elect to include the entire reserve balance in income in the first taxable year beginning after 1985. | Same as President's proposal for "large" banks (assets in excess of $500 million). Present law retained for other banks.<br>*Effective date.*—Taxable years beginning after 1985. The existing reserve balance on the effective date is to be included in income ratably over a 5-year period starting with the first taxable year beginning after 1985. Taxpayers could elect the amount to be recaptured in the first taxable year beginning after 1985, and ratably recapture the balance over the next 4 years. Taxpayers could also elect to account for existing loans using a "cutoff" method. | Same as President's proposal for all banks.<br>*Effective date.*—Same as the House bill, except that 1986 would be substituted for 1985. |
| **2. Thrift institutions** | Thrift institutions may deduct loan losses, prior to the time that loans become wholly or partially worthless, using the reserve methods available to banks (the "experience" and "percentage of eligible loans" methods) or the "percentage of taxable income" method, which is available only to thrifts. The percentage of eligible loans method is scheduled to expire for taxable years beginning after 1987.<br>Under the percentage of taxable income method, an annual deduction is allowed for 40 percent of taxable income if 82 percent of the thrift's assets are qualified (72 percent for mutual savings banks without stock). The deduction phases down to zero when less than 60 percent of the thrift's assets are qualified (50 percent for mutual savings banks without stock). Qualified assets include home mortgage loans and certain other assets. | Use of the experience, percentage of eligible loans, and percentage of taxable income methods would be repealed. Deductions for loan losses would be allowed when the loans are partially or wholly worthless (i.e., the "specific charge-off" method).<br>*Effective date.*—Taxable years beginning after 1985. The portion of the bad debt reserve on the effective date which is equal to the greater of the reserve balance computed under the experience and percentage of eligible loans methods would be included in income ratably over a 10-year period starting with the first taxable year beginning after 1985. Taxpayers could elect to include the entire recapture amount in the first taxable year beginning after 1985. | Thrift institutions using the reserve method to compute their losses on bad debts may use the experience method allowed commercial banks under present law or the percentage of taxable income method with the percentage of taxable income method with the percentage reduced from 40 percent to 5 percent. An institution must hold at least 60 percent of its assets as qualifying assets to be considered a "thrift institution" for this purpose.<br>*Effective date.*—Taxable years beginning after 1985. | Same as House bill.<br>*Effective date.*—Taxable years beginning after 1986. |

## IX. FINANCIAL INSTITUTIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **B. Interest on Debt Used to Purchase or Carry Tax-Exempt Obligations** | No deduction is allowed for interest payments on debt incurred or continued to purchase or carry tax-exempt obligations. Under a long-standing judicial and administrative interpretation, financial institutions generally are permitted to invest deposited funds in tax-exempt obligations, while continuing to deduct interest paid to depositors.<br>The corporate tax preference rules reduce by 20 percent the amount which may be deducted by financial institutions for interest on funds allocable to tax-exempt obligations acquired after 1982. The portion of funds allocable to tax-exempt obligations is deemed to be equivalent to the ratio of—<br>(i) the average annual adjusted basis of tax-exempt obligations acquired after 1982 and held by the financial institutions, to<br>(ii) the average annual adjusted basis of the financial institution's total assets. | Denies financial institutions 100 percent of interest deductions that are allocable to tax-exempt obligations acquired on or after January 1, 1986. The amount of interest allocable to tax-exempt obligations would be determined in the same manner as for purposes of the tax preference reduction under present law.<br>The present law (i.e., 20 percent) reduction would continue to apply with respect to tax-exempt obligations acquired in 1983 through 1985. | Same as President's proposal, but specifies that the interest disallowance rule is to be applied before the rules requiring capitalization of certain preproduction expenses (new sec. 263A).<br>*Effective date.*—Generally, obligations acquired after 1985. Transitional exceptions are provided for—<br>(1) Obligations acquired pursuant to written commitments to purchase or repurchase, entered into before September 25, 1985, and<br>(2) Tax anticipation notes with a term not to exceed one year, or bonds for public project financing (not exceeding $3 million per issue), which notes or bonds are issued between January 1, 1986 and December 31, 1988 and acquired by a financial institution authorized to do business in the State of the bond issuer. Not more than $10 million of obligations may be designated for this purpose by any issuer during any calendar year. | Same as House bill.<br>*Effective date.*—Generally, obligations acquired on or after March 1, 1986. Transitional exceptions are provided for—<br>(1) Obligations acquired pursuant to written commitments to purchase or repurchase, entered into before March 1, 1986; and<br>(2) Tax anticipation notes with a term not to exceed one year, or bonds for public project financing (not exceeding $3 million per issue), which notes or bonds are issued between March 1, 1986 and December 31, 1988 and acquired by a financial institution authorized to do business in the State of the bond issuer. Not more than $10 million of obligations may be designated for this purpose by any issuer during any calendar year. |

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **C. Reorganizations of Financially Troubled Thrift Institutions**<br>**1. Qualification for tax-free status** | Continuity of proprietary interest is generally a prerequisite to qualification of a transaction as a tax-free reorganization. Thus, the equity owners of the acquired corporation must retain a substantial continuing interest in the acquiring corporation. The Code contains a special provision under which a merger of a financially troubled thrift institution into another corporation may qualify as a reorganization even though continuity of proprietary interest is absent. | The special rules relating to qualification of an acquisition of a financially troubled thrift as a tax-free reorganization would be repealed.<br>*Effective date.*—Acquisitions on or after January 1, 1991. | Same as President's proposal.<br>*Effective date.*—Acquisitions on or after January 1, 1986. | Same as President's proposal.<br>*Effective date.*—Acquisitions on or after January 1, 1989. |
| **2. Net operating losses** | The rules limiting use of an acquired corporation's net operating loss carryovers by the acquiring corporation are relaxed in certain situations for troubled thrift reorganizations. | The special treatment of net operating losses in a troubled thrift reorganization would be repealed.<br>*Effective date.*—Acquisitions on or after January 1, 1991. | Same as President's proposal.<br>*Effective date.*—Acquisitions on or after January 1, 1986. | Same as President's proposal. (see also VI.A.6).<br>*Effective date.*—Acquisitions on or after January 1, 1989. |
| **3. FSLIC payments** | Payments received by certain financially troubled thrifts from the Federal Savings and Loan Insurance Corporation (FSLIC) are not income to the recipient and are exempt from the general requirement that a taxpayer's basis in its assets be reduced by nonshareholder contributions to capital. | The special rules relating to the exclusion from income, or exemption from the basis reduction requirement, of FSLIC payments to troubled thrifts would be repealed.<br>*Effective date.*—Payments on or after January 1, 1991. | Same as President's proposal.<br>*Effective date.*—Payments on or after January 1, 1986. In addition, present law would be clarified by providing that FSLIC payments to financially troubled thrifts exempt under the present-law exclusion are not subject to the provision disallowing expenses attributable to such payments. | Same as President's proposal.<br>*Effective date.*—Payments on or after January 1, 1989. |

## IX. FINANCIAL INSTITUTIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **D. Credit Unions** | Credit unions are exempt from Federal income tax. | Repeals tax exemption for credit unions having assets of $5 million or more.<br>Taxable credit unions would be subject to the same general tax rules as would apply to thrift institutions (e.g., savings and loan associations and mutual savings banks).<br>*Effective date.*—Taxable years beginning on or after January 1, 1986. | No provision. | Retain present law. |
| **E. Special Rules for Net Operating Loss Carryovers of Depository Institutions** | Commercial banks and thrift institutions may carry net operating losses back to the preceding ten taxable years and forward to the succeeding five taxable years. This contrasts with the general rule for other taxpayers allowing a net operating loss to be carried back to the preceding three taxable years and forward to the succeeding 15 taxable years. | The special carryback and carryforward rules applicable to commercial banks and thrift institutions would be repealed. Commercial banks and thrift institutions would carryback and carryforward net operating losses under the general rule applicable to other taxpayers (3-year carryback; 15-year carryforward).<br>*Effective date.*—Change applies to net operating losses incurred in taxable years beginning on or after January 1, 1986. Net operating losses incurred in earlier years would continue to be subject to the rules of present law. | Same as President's proposal. | Generally, the same as the President's proposal. Net operating losses incurred in taxable years ending after December 31, 1980 and before January 1, 1986 would be eligible to be carried forward 8 years. |
| **F. Treatment of Losses on Deposits in Insolvent Financial Institutions** | A loss realized by a taxpayer with respect to a deposit or account in a financial institution is deductible in the year in which it is determined that there is no prospect of recovery, in the same manner as any other type of bad debt loss. Unless the deposit was created in connection with a trade or business of the taxpayer, the loss is treated as a short-term capital loss, the deduction of which is limited under the Code. | No provision. | Individuals may elect to deduct losses on deposits or accounts in certain types of financial institutions as a casualty loss at the time the loss can be reasonably estimated. The election applies only where the loss arises as a result of the bankruptcy or insolvency of the financial institution.<br>*Effective date.*—Losses in taxable years after December 31, 1982. | Retain present law. |

## X. FOREIGN TAX PROVISIONS

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **A. Foreign Tax Credit**<br>**1. Foreign tax credit limitation**<br>***a. Overall limitation*** | (a) The foreign tax credit is determined on an "overall" basis: a taxpayer adds up its net income and net losses from all sources outside the United States and calculates one aggregate limitation based on the total. The credit is limited to the pre-credit U.S. tax multiplied by a fraction, the ratio of foreign source income to worldwide income. | (a) Determine the foreign tax credit limitation on a per country basis instead of on an overall basis. That is, a taxpayer could credit taxes paid on income derived from a particular country only up to the amount of U.S. tax that would be owed on *that* income. | (a) Does not adopt the per country limitation. | (a) Does not adopt the per country limitation. |
| ***b. Separate limitations for different types of income*** | (b) Overall foreign tax credit limitations are calculated separately for certain categories of income that frequently bear either high (e.g., oil extraction income) or low (e.g., FSC dividends) rates of foreign tax or that can easily be earned in low-tax countries rather than in the United States in order to inflate the foreign tax credit limitation. The reason for the separate limitations is to prevent distortion of the foreign tax credit. | (b) Generally retain the present law separate limitations, but apply them on a country-by-country basis if the per country limitation is adopted. The application of the separate limitation for interest would be extended to certain other types of income. Dividends generally would be subject to the various separate limitations in proportion to the types of income out of which the dividends were paid. | (b) As an alternative to the President's per country limitation proposal, establish separate limitations for (1) banking and insurance income, (2) shipping income, and (3) foreign currency translation gains, respectively, and replace the separate limitation for passive interest income with a separate limitation for passive income generally. | (b) Same as present law, except replace the separate limitation for passive interest income with a separate limitation for passive income generally. Foreign currency translation gains would not be subject to a separate limitation. |
| | | | Passive income, for this purpose, generally is subpart F foreign personal holding company (FPHC) income as that category of income is modified by the House bill to include: | Passive income, for this purpose, generally is FPHC income (as defined under subpart F) as modified to include: |
| | | | (1) gain from the sale of any property that gives rise to passive income; | (1) gain from the sale of property unless the property produces income that is not passive; |
| | | | (2) income from commodities transactions generally (subject to an exception for hedging transactions and for active producers, processors, merchants, or handlers of commodities); | (2) same as House bill; |
| | | | (3) foreign personal holding company inclusions (under sec. 553) and passive foreign investment company inclusions, | (3) same as House bill; |
| | | | (4) foreign currency transaction gains of dollar taxpayers and passive foreign currency transaction gains; and | (4) passive foreign currency transaction gains only; |
| | | | (5) passive leasing income generally. | (5) same as House bill; and |
| | | | | (6) income from a non-bona fide bank. |
| | | | Certain payments from related persons are subject to a look-through rule. | Certain payments from related persons would be subject to a look-through rule. |
| | | | The separate limitation for passive income does not apply to high-taxed income; foreign oil and gas extraction income; or active business rents and royalties from unrelated persons. | Passive income would not include foreign oil and gas extraction income; interest on working capital (as under current law); or active business rents and royalties from unrelated persons. The separate limitation would be subject to an anti-abuse rule to prevent taxpayers from recharacterizing active income as passive income. |

## X. FOREIGN TAX PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **A. Foreign Tax Credit (Cont.)**<br>**1. Foreign tax credit limitation (Cont.)** | | | | |
| *c. Foreign tax credit carryovers and carrybacks* | (c) Foreign taxes in excess of the foreign tax credit limitation may be carried back two years and then carried forward five years. | (c) If the per country limitation is adopted, extend the foreign tax credit carryover period from five to 10 years. | (c) Retain present law. | (c) Retain present law. |
| *d. Election to credit or deduct foreign tax* | (d) The foreign tax credit is elective. Taxpayers may deduct foreign income taxes if they prefer. However, a taxpayer that elects to credit any foreign income taxes paid in a particular year may not deduct other foreign income taxes paid that year. | (d) If the per country limitation is adopted, permit taxpayers to make the election to deduct or to credit foreign taxes on a country-by-country basis.<br>*Effective date.*—Generally, taxable years beginning after 1985. The 10-year carryover period would apply only to excess credits generated after January 1, 1986. | (d) Retain present law.<br>*Effective date.*—Taxable years beginning after 1985. | (d) Retain present law.<br>*Effective date.*—Taxable years beginning after 1986. |
| 2. Credit for taxes in lieu of income taxes | (a) The foreign tax credit is available for income, war profits, and excess profits taxes paid to a foreign country or a U.S. possession. In certain cases, a tax other than an income tax is creditable if it serves as a substitute for an income tax. Under the overall limitation, U.S. lenders can use foreign tax credits for high gross withholding taxes on a loan—the economic burden of which may be borne primarily by the borrower—to reduce the lenders U.S. tax liability on other loan proceeds and other income. | No provision. | (a) As an alternative to the President's per country limitation proposal, a foreign tax credit is allowed for gross-basis taxes on interest paid to a bank, insurance company or other financial institution only to the extent of the U.S. tax on the associated interest income. | (a) Create a separate foreign tax credit limitation for all foreign interest (other than related party interest) earned by a financial institution that is subject to a foreign withholding tax of 5 percent or more. |
| | (b) Under Treasury regulations, a tax is not creditable if it is used directly or indirectly as a subsidy to the taxpayer or certain related persons. | | (b) Codify the Treasury regulation that denies a foreign tax credit for taxes used as a subsidy to the taxpayer or certain related persons.<br>*Effective date.*—In general, the provisions would apply to foreign taxes paid or accrued in taxable years beginning after 1985. The credit limitation for gross basis taxes on interest would not apply until 1989 in the case of foreign taxes imposed on interest paid on pre-November 17, 1985 loans to borrowers in 15 less developed countries. | (b) Codify the regulation to treat direct or indirect subsidies, including a subsidy to a party to a related transaction, as a reduction of creditable taxes.<br>*Effective date.*—In general, the provisions would apply to foreign taxes paid or accrued in taxable years beginning after 1986. The credit limitation for gross basis taxes on interest would not apply until 1990 in the case of foreign taxes imposed on interest paid on pre-November 17, 1985 loans to borrowers in 15 less developed countries. |

## X. FOREIGN TAX PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **3. Effect of losses on foreign tax credit** | (a) Under the overall foreign tax credit limitation, a taxpayer first uses a net loss incurred in any foreign country to reduce its income from other foreign countries. If a taxpayer's net foreign losses subject to one separate limitation exceed its foreign income subject to that limitation, the excess arguably reduces the taxpayer's U.S. source taxable income. | (a) If the per country limitation is adopted, a net loss incurred in any foreign country would reduce taxable income earned in all other countries, including the United States, in proportion to the shares of worldwide taxable income of each of those other countries. | (a) Provide that foreign losses first reduce income in the other baskets before they reduce U.S. income. Provide a recapture rule. | (a) Same as House bill. |
| | (b) Oil and gas extraction losses incurred abroad are treated separately from other foreign losses so that the rules segregating oil and gas income (which often bears an abnormally high rate of tax abroad) for foreign tax credit limitation purposes can be effectively applied. | (b) If the per country limitation is adopted, the separate rules governing the treatment of foreign oil and gas extraction losses would be repealed. | (b) Retain present law. | (b) Retain present law. |
| | (c) An overall U.S. loss first reduces foreign income earned in the loss year and hence pre-credit U.S. tax in that year. | (c) An overall U.S. loss would continue to reduce foreign income. If the per country limitation is adopted, the U.S. loss would be prorated against income earned by the taxpayer in different foreign countries in proportion to the shares of worldwide taxable income of each of the countries. In addition, if a per country limitation is adopted, the proposal would add an overall U.S. loss recapture rule. Under this rule, a portion of U.S. income earned after an overall U.S. loss year would be treated as foreign income. | (c) Retain present law. | (c) Provide that U.S. losses reduce categories of foreign income pro rata. |
| | | *Effective date.*—Generally, taxable years beginning after 1985. Pre-effective date overall foreign losses would be recaptured from post-effective date income under the pre-effective date foreign loss recapture rules. | *Effective date.*—The changes would be effective with respect to losses incurred in taxable years beginning after 1985. | *Effective date.*—The changes would be effective with respect to losses incurred in taxable years beginning after 1986. |

### X. FOREIGN TAX PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **4. Deemed-paid credit** | A U.S. corporation that owns at least 10 percent of a foreign corporation's voting stock and that has dividend income from the foreign corporation may generally take a "deemed-paid" credit for a share of the foreign taxes that the foreign corporation paid on the earnings out of which the dividend is paid. A similar credit applies when a 10 percent U.S. corporate shareholder includes in income a portion of a controlled foreign corporation's undistributed earnings under subpart F.<br>A dividend or subpart F inclusion is considered paid first from earnings and profits of the current year and then from accumulated profits of each preceding year. Actual distributions made in the first 60 days of a taxable year are treated as made from the prior year's earnings and profits.<br>Earnings and profits may be computed in a different manner for actual dividend distributions than for subpart F inclusions. | A U.S. corporation's share of foreign taxes paid by a foreign corporation would depend on the percentage of the foreign corporation's multi-year pool of accumulated earnings and profits represented by the dividend, including current year earnings and profits. The 60-day rule would be repealed.<br>Earnings and profits would be computed in the same manner for actual distributions and for subpart F inclusions, generally following the subpart F rules. However, the rules for translating foreign currency would be modified.<br>*Effective date.*—Taxable years beginning after 1985. Future dividends would be treated as paid first out of accumulated profits of the payor derived after the effective date. Dividends in excess of that amount would be treated as paid out of pre-effective date accumulated profits under present-law ordering rules. | Same as President's proposal.<br>*Effective date.*—Same as President's proposal. | Same as President's proposal, but draw taxes and earnings and profits from a moving 10-year pool.<br>*Effective date.*—Same as President's proposal, but effective for taxable years beginning after 1986 rather than 1985. |

## X. FOREIGN TAX PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **B. Source Rules** | | | | |
| **1. Income derived from purchase and sale of inventory-type property** | Generally sourced where title to the property passes. The title passage rule allows taxpayers to obtain foreign sourcing for sales income by passing title to the property sold offshore regardless of where the economic activity generating the income took place. | Eliminate the title passage rule. Generally source in the country of residence of the seller. If the seller has a fixed place of business outside the country of residence that participates materially in the sale, source where that fixed place of business is located. The fixed place of business exception would not apply in the case of sales to related foreign persons. | Generally, same as President's proposal, but provide anti-abuse rules to prevent manipulation of the basic residence-of-the-seller source rule. Clarify that, for purposes of the fixed place of business exception, no fixed place of business exists in a country with respect to income which that country is barred by treaty from taxing. | Present law but provide that effectively connected income earned by a foreign person through a U.S. business is U.S. source (except for foreign tax credit purposes). |
| | | *Effective date.*—Generally, taxable years beginning after 1985. Transitional rules would be provided for sales made under unrelated party contracts entered into before 1986. | *Effective date.*—Generally, same as President's proposal, but apply transition rule only to sales during 1986. | *Effective date.*—Transactions entered into after March 18, 1986. |
| **2. Income from manufacture and sale of inventory-type property** | (a) Sales income is sourced under the title passage rule described in 1., above. | (a) Eliminate the title passage rule for the sales portion of such income and source that portion of the income generally in the country of residence of the seller, with an exception for foreign material participation in unrelated party sales. | (a) For the sales portion of such income, generally the same as the President's proposal but provide anti-abuse rules to prevent manipulation of the basic residence-of-the-seller source rule and clarify that, for purposes of the fixed place of business exception, no fixed place of business exists in a country with respect to income which that country is barred by treaty from taxing. Provide special rule for foreign sales by U.S. companies to ensure foreign source for sales of foreign-produced property. | (a) Present law but provide that effectively connected income earned by a foreign person through a U.S. business is U.S. source (except for foreign tax credit purposes). |
| | (b) Under Treasury regulations, half of the income is treated as manufacturing and sourced in the country of manufacture and half is treated as sales income. The division of such income between manufacturing and sales may be made on the basis of an independent factory price instead if one exists. | (b) Source the manufacturing portion of such income as under present law. Retain the 50/50 formula and independent factory price option for allocating such income between manufacturing and sales activity. | (b) Require that *at least* 50 percent of such income be allocated to manufacturing activity under regulations. | (b) Retain present law. |
| | | *Effective date.*—Taxable years beginning after 1985. Transitional rules would be provided for sales made under unrelated party contracts entered into before 1986. | *Effective date.*—Generally, same as President's proposal. Apply transition rule only to sales during 1986. | *Effective date.*—Transactions entered into after March 18, 1986. |

## X. FOREIGN TAX PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **3. Income from the sale of intangible property** | Generally, income from sales of intangible property is sourced under the title passage test described in 1., above. Some income from sales of intangible property for an amount contingent on the use of the property is sourced where the property is used. | Income from sales of intangibles would have its source at the place of use.<br>*Effective date.*—Generally, taxable years beginning after 1985. Transitional rules would be provided for sales made under unrelated party contracts entered into before 1986. | Source income from sales of intangibles (except sales for amounts contingent on the use of the intangibles) generally in the country of residence of the seller, but provide anti-abuse rules and clarify that no fixed place of business exists in a country with respect to income which that country is barred by treaty from taxing. Source income from sales of goodwill where the goodwill was developed.<br>*Effective date.*—Generally, same as President's proposal. Apply transition rule only to sales during 1986. | Same as House bill, except:<br>(1) effectively connected income earned by a foreign person through a U.S. business is U.S. source (except for foreign tax credit purposes), and<br>(2) for U.S. persons, sales involving foreign material participation would yield foreign source income (if such income is subject to more than a de minimis amount of foreign tax).<br>*Effective date.*—For U.S. persons and controlled foreign corporations, taxable years beginning after 1986. For other foreign persons, transactions entered into after March 18, 1986. |
| **4. Income derived from sale of other personal property** | Generally sourced under the title passage rule described at item 1., above. | (a) Income derived from sales of personal property used by the seller in his business would be sourced where the property was used.<br>(b) Income derived from sales of other personal property, including passive investment property such as securities and commodity futures contracts, would be sourced in the country of residence of the seller.<br>*Effective date.*—Generally, taxable years beginning after 1985. Transitional rules would be provided for sales made under unrelated party contracts entered into before 1986. | (a) Source recapture income derived from sales of personal property used by the seller in his business where deductions with respect to such property previously offset income, to the extent of such deductions. Source any sales income exceeding previous deductions under rules similar to those proposed by the President for income from the purchase and sale of inventory-type property (in the country of residence of the seller) but provide anti-abuse rules and clarify that no fixed place of business exists in a country with respect to income which that country is barred by treaty from taxing.<br>(b) Same as President's proposal.<br>*Effective date.*—Generally, same as President's proposal. Apply transition rule only to sales during 1986. | (a) For recapture income, same as House bill. For gain in excess of recapture income, present law is retained.<br>(b) Residence of the seller, except:<br>(1) gain from stock sales would be foreign source to the extent subject to U.S. tax at ordinary income rates (under sec. 1248),<br>(2) for U.S. persons, sales involving foreign material participation would yield foreign source income (if such income is subject to more than a de minimis amount of foreign tax), and<br>(3) effectively connected income earned by a foreign person through a U.S. business would be U.S. source (except for foreign tax credit purposes).<br>*Effective date.*—For U.S. persons and controlled foreign corporations, taxable years beginning after 1986. For other foreign persons, transactions entered into after March 18, 1986. |

## X. FOREIGN TAX PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **5. Transportation income**<br>*a. Source of income* | (a) Treasury regulations generally allocate transportation services income between U.S. and foreign sources in proportion to the expenses incurred in providing the services. Expenses incurred outside the three-mile limit to the territorial waters of the United States are treated as foreign for this calculation. Income and losses from transportation that begins and ends in the United States are sourced in the United States. Income and losses from transportation that begins in the United States and ends in a U.S. possession (or vice versa) generally is treated as 50-percent U.S. source and 50-percent possessions source. | (a) Reassess the rule allocating transportation income to U.S. and foreign sources in proportion to where expenses are incurred; possibly substitute for it a 50-percent rule similar to that for U.S.-U.S. possessions transportation income. | (a) Source transportation income and loss attributable to U.S.-foreign and foreign-U.S. routes as 50-percent U.S. and 50-percent foreign. | (a) Same as House bill, but exclude personal services performed as an employee. |
| *b. Special rules for vessels and aircraft* | (b)(1) Under a special rule, income and expenses associated with the lease or disposition of a vessel or aircraft that is constructed in the United States and leased to U.S. persons are sourced in the United States, regardless of where the vessel or aircraft may be used. | (b)(1) Repeal special rule. | (b)(1) Same as President's proposal. | (b)(1) Same as President's proposal. |
| | (2) A similar rule applies to transportation income and expenses associated with the lease of an aircraft (wherever constructed) to a regularly scheduled U.S. air carrier, to the extent the aircraft is used on U.S.-U.S. possessions routes. | (2) Retain present law. | (2) Repeal. | (2) Same as House bill. |
| *c. Reciprocal exemption* | (c) The United States does not tax foreign persons' earnings from the operation of ships and aircraft registered in foreign countries that grant equivalent exemptions to U.S. citizens and U.S. corporations. | (c) Retain present law. | (c) Modify the exemption for foreign persons' shipping and aircraft income so that its availability turns on whether a foreign person's *residence* country gives U.S. citizens and U.S. corporations an equivalent foreign tax exemption, not on whether the country where the ship or aircraft is registered gives such an exemption. Provide anti-conduit rules. | (c) Same as House bill. |
| *d. Gross-basis withholding tax* | (d) The United States (in contrast with a number of countries) does not impose a gross-basis tax on domestic source shipping income of foreign persons. | (d) Retain present law. | (d) Impose a four-percent gross-basis tax on U.S source transportation income of foreign persons, unless prohibited by treaty or reciprocal exemption (with anti-conduit rules to prevent treaty shopping). Collect the tax through a withholding requirement. Transportation income is effectively connected only in limited cases. | (d) Same as House bill, but limit its application to residents of countries that impose gross tax on transportation income of U.S. persons. Do not modify the definition of effectively connected income. |
| | | *Effective date.*—Generally, taxable years beginning after 1985. The repeal of the special U.S. sourcing rules for certain leasing income would not affect income attributable to an asset owned on January 1, 1986, if that asset was first leased before that date. | *Effective date.*—Same as President's proposal. | *Effective date.*—Same as President's proposal, but substitute 1986 for 1985. |

BLANK PAGE

BLANK PAGE

BLANK PAGE

## X. FOREIGN TAX PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **6. Other offshore income and income earned in space** | Generally, treated as foreign source income. Some taxpayers treat certain space-related income as U.S. source income. | No provision. | Source other offshore income and income earned in space in the recipient's country of residence. Treat U.S.-controlled foreign corporations as U.S. residents for purposes of this rule.<br>*Effective date.*—Taxable years beginning after 1985. | Same as House bill.<br>*Effective date.*—Taxable years beginning after 1986. |
| **7. Dividend and interest income** | (a) Generally sourced in the residence country of the payor (in the case of a corporation, its country of incorporation). However, if a U.S. corporation earns more than 80 percent of its income from foreign sources (such a corporation is known as an "80/20 company)", dividends and interest paid by the corporation are treated as foreign source income. | (a) Repeal the exceptions to the general source rules for interest and dividends paid by 80/20 companies. | (a) Apply the general source rules to dividends paid by 80-20 companies (i.e., treat as U.S. source). Treat interest paid by 80/20 companies as foreign source for withholding purposes, to the extent that the company's income is derived from foreign sources in the active conduct of a trade or business outside of the United States. However, treat as U.S. source interest paid to related persons by a foreign-controlled 80-20. For foreign tax credit purposes, treat interest as U.S. source, unless the income is connected with an active financing business of an unrelated U.S. payee conducted outside the United States. | (a) For foreign payees, follow President's proposal as modified by House bill. For U.S. payees, retain present law but adopt look-through rules to ensure that the U.S. source portion of the dividend and interest is subject to U.S. tax. |
|  | (b) Present law effectively exempts from U.S. tax some categories of interest income when earned by foreign persons (for example, interest earned on U.S. bank deposits) by treating the income as foreign source. | (b) Retain the present law exemptions but restructure some of them (including that for U.S. bank deposits) as overt exemptions and treat the interest subject to the restructured exemptions as U.S. source. | (b) Same as President's proposal. | (b) Same as President's proposal. |
|  |  | *Effective date.*—Generally, taxable years beginning after 1985. The modification of the source rule for interest paid by 80/20 companies would apply to interest paid on debt obligations incurred after January 1, 1986. | *Effective date.*—Same as President's proposal, with a targeted transitional rule | *Effective date.*—Taxable years beginning after 1986. |

## X. FOREIGN TAX PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **8. Allocation of interest and other expenses** | (a) Under Treasury regulations, taxpayers generally allocate interest and other expenses between gross U.S. and gross foreign income on a separate, company-by-company basis, even if they are members of an affiliated group. The separate company allocation rule conflicts with a Court of Claims case, decided before the regulations became effective, which indicates that expenses that are not definitely allocable against U.S. or foreign gross income should be deducted from gross income on a consolidated group basis. | (a) Corporations joining in filing a consolidated return (but not other corporate members of affiliated groups) would be required to allocate interest expense on a consolidated group basis rather than on a company-by-company basis. | (a) Require all corporate members of affiliated groups to allocate all expenses (not interest only) on a consolidated group basis. Permit same corporations that cannot join in filing consolidated returns to continue allocating expenses on a separate company basis. Permit financial institutions to continue allocating expenses on a separate company basis if their borrowing and lending activities are independent. | (a) Same as President's proposal as modified by House bill (without exception for financial institutions), but take borrowings by foreign affiliates into account. |
| | (b) Generally, under Treasury regulations, interest expense is allocated between U.S. and foreign income on the basis of the value of the taxpayer's assets that generate U.S. and foreign income. For affiliates, only stock basis is taken into account. | (b) No provision. | (b) Modify the asset method of allocating interest expense by looking to earnings and profits of foreign corporations, so that changes in value of foreign assets are taken into account. | (b) Modify House bill to take assets of affiliates (instead of stock basis) into account (including debt-financed assets). |
| | (c) Optional gross income methods for apportioning interest expense are also available under the regulations. | (c) No provision. | (c) Eliminate the optional gross income methods for apportioning interest expense. | (c) Same as House bill. |
| | (d) Taxpayers generally may take into account tax-exempt income and assets in allocating deductible interest and other expenses. Since tax-exempt income and assets are generally U.S.-based, taxpayers can drive a second tax benefit (higher foreign income and, hence a higher foreign tax credit limitation) from ownership of tax-exempt assets. | (d) Tax-exempt income and assets generating tax-exempt income would not be taken into account for purposes of allocating interest expense. | (d) Same as President's proposal. | (d) Same as President's proposal. |
| | | *Effective date.*—Generally, taxable years beginning after 1985. Tax-exempt obligations held before 1986, and income derived from such obligations, could continue to be taken into account for purposes of allocating interest expenses. | *Effective date.*—Generally, same as President's Proposal. The allocation of interest on pre-existing loans is phased in over a three-year period. An alternative transitional rule permits up to a five-year phase-in of the consolidated group rule for recent loans, and a targeted transitional rule is provided. | *Effective date.*—Generally taxable years beginning after 1986, but the allocation of interest on existing loans is phased in over 4 years. |

## X. FOREIGN TAX PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **C. U.S. Taxation of Income Earned Through Foreign Corporations**<br>**1. Tax haven income subject to current tax**<br>***a. Tax haven income generally*** | (a)(1) In general, no current U.S. tax applies to the foreign income of a foreign corporation, and a U.S. investor in a foreign corporation is taxed only when income is distributed to him. However, the deferral of U.S. tax on the income of U.S.-owned foreign corporations does not apply to certain kinds of income that are suited to tax haven operations. Under the Code's subpart F rules, when a U.S.-controlled foreign corporation earns this tax-haven income, the United States will generally tax the corporation's 10-percent U.S. shareholders currently.<br>Subpart F income includes foreign personal holding company (FPHC) income, consisting generally of several types of passive income. Some passive income is not included in FPHC income, however. | (a)(1) None. | (a)(1) Add the following types of passive income to FPHC income for subpart F purposes:<br>(i) gain from the sale of any property that gives rise to passive income (not limited to stocks and bonds as under present law);<br>(ii) income from commodities transactions generally (subject to exceptions for hedging transactions and for active producers, processors, merchants, or handlers of commodities);<br>(iii) (with a business needs exception) foreign currency gains generally; and<br>(iv) passive leasing income generally. | (a)(1) Generally retain present law, but add the following types of passive income to FPHC income for subpart F purposes:<br>(i) gain from the sale of property unless it produces income that is not passive income;<br>(ii) same as House bill;<br>(iii) same as House bill;<br>(iv) same as House bill. |
| | | | The exclusion from FPHC income of certain payments from related persons in the same foreign country would be limited by a look-through rule that takes into account the FPHC income of related party payor. | Same as House bill. |
| | | | Tax currently income from rents and royalties routed through a related party in a country that is neither the country of creation nor of use. | Retain present law. |
| | (2) Subpart F income also includes foreign base company shipping income (which excludes shipping income reinvested in shipping operations). | (2) None. | (2) Repeal the reinvestment exception so as to tax shipping income currently. | (2) Retain present law. |
| | (3) Subpart F income does not generally include interest, dividends, and securities gains earned by banks. This banking exception applies to some corporations that are not bona fide, active banks. | (3) None. | (3) The subpart F banking exception is repealed. | (3) Same as present law, except provide that the banking exception from subpart F applies only to bona fide, active banking operations. |

## X. FOREIGN TAX PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| *a. Tax haven income generally (Cont.)* | (4) Other categories of subpart F income include certain income from the insurance of U.S. risks and foreign base company income from certain sales and services (including insuring related persons' third-country risks). Foreign corporate earnings from insuring foreign risks of unrelated persons are not subject to current U.S. tax under subpart F. | (4) None. | (4) Amend the definition of tax haven income to include income from the insurance of unrelated persons' risks outside of the insuring company's country of incorporation; repeal the 5-percent de minimis exception for income from the insurance of U.S. risks. | (4) Retain present law. |
| | (5) Current U.S. tax is generally not imposed under subpart F if the IRS finds that a U.S.-controlled foreign corporation was not formed or used to avoid tax. | (5) None. | (5) Replace the subjective tax-avoidance test with an objective test that looks to the rate of foreign tax paid by a U.S.-controlled foreign corporation, allowing the IRS to determine whether income (otherwise subject to subpart F) is properly treated as tax-haven income. | (5) Retain present law. |
| | (6) Controlled partnerships are not treated as related persons for purposes of the subpart F rules that tax certain transactions with related persons. | (6) None. | (6) Treat a partnership that is controlled by a CFC as a related person for purposes of subpart F. | (6) Same as House bill. |
| | | | *Effective date.*—Taxable years of foreign corporations beginning after 1985. | *Effective date.*—Taxable years of foreign corporations beginning after 1986. |
| *b. Determination of U.S. control of foreign corporation* | (b) The rules that impose U.S tax currently on tax haven income of a foreign corporation apply only if a U.S. ownership requirement is satisfied: more than 50 percent of the voting power of the corporation must belong to U.S. persons each of which owns at least 10 percent of the voting power. Older, similar, but less extensive rules requiring current U.S. taxation—the foreign personal holding company (FPHC) rules—apply only if more than 50 percent of the value of the corporation belongs to five or fewer U.S. individuals. | (b) None. | (b) Amend the U.S. ownership requirements for imposition of the anti-tax haven and FPHC rules. For the anti-tax haven rules to apply, 50 percent or more (rather than more than 50 percent) of the vote or value (not merely vote) of a foreign corporation would have to belong to 10-percent U.S. shareholders. Similarly, for the FPHC rules to apply, 50 percent or more (rather than more than 50 percent) of the vote or value of a foreign corporation would have to be owned by five or fewer U.S. individuals. | (b) Retain more than 50 percent test of present law and adopt vote or value rule of House bill. |
| | | | *Effective date.*—Generally, taxable years beginning after 1985. The change to the "50-percent or more" test would not apply to taxable years of foreign corporations beginning during 1986. | *Effective date.*—Taxable years beginning after 1986. Under a transition rule, deficits in earnings and profits accrued, and U.S. property acquired, in taxable years beginning before 1987, would be exempt from the application of the anti-tax haven rules that would otherwise result from the change made by the provision. |
| *c. De minimis tax haven income rule* | (c) The rules that impose current U.S. tax on foreign base company income (a type of tax haven income) of a foreign corporation apply only if certain threshold requirements are met. One such requirement is that 10 percent or more of the foreign corporation's gross income must be tax haven income. If more than 70 percent of the foreign corporation's gross income is base company income, all of its gross income is treated as base company income. | (c) None. | (c) Apply the de minimis and 70-percent rules for foreign base company income on the basis of net income instead of gross income.<br>*Effective date.*—Taxable years of foreign corporations beginning after 1985. | (c) Same as House bill.<br>*Effective date.*—Taxable years of foreign corporations beginning after 1986. |

### X. FOREIGN TAX PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| *d. Possessions corporations* | (d) A corporation chartered in a U.S. possession with at least 80 percent of its income derived in the possessions and no more than 50 percent of its gross income from passive investments is not treated as a controlled foreign corporation; thus U.S. tax on its tax haven income is deferred. | (d) This exception to the anti-tax haven rules would be repealed.<br>*Effective date.*—Taxable years beginning after 1985. Under a transition rule, deficits in earnings and profits accrued, and property acquired, in taxable years beginning before 1986, would be exempt from the application of the anti-tax haven rules that would otherwise result from the repeal of the exception for corporations chartered in the possessions. | (d) Same as President's proposal.<br>*Effective date.*—Same as President's proposal. | (d) Same as President's proposal.<br>*Effective date.*—Taxable years beginning after 1986. Under a transition rule, deficits in earnings and profits accrued, and U.S. property acquired, in taxable years beginning before 1987, would be exempt from the application of the anti-tax haven rules that would otherwise result from the repeal of the exception for corporations chartered in the possessions. |
| **2. Application of accumulated earnings tax and personal holding company tax to foreign corporations** | The accumulated earnings tax (AET) and personal holding company (PHC) tax are imposed on corporations that accumulate earnings rather than distributing them to their shareholders. The taxes are imposed on "accumulated taxable income" and "undistributed personal holding company income," respectively. Those amounts are calculated by making several adjustments to the regular taxable income of a corportion, including deductions for capital gains (and certain capital losses). | None. | For purposes of calculating the AET or PHC tax applicable to a foreign corporation, allow an adjustment for net capital gains only if they are effectively connected with the conduct of a U.S. trade or business.<br>*Effective date.*—The amendments would apply to gains and losses realized on or after November 16, 1985. | Same as House bill.<br>*Effective date.*—The amendments would apply to gains and losses realized on or after March 1, 1986. |

## X. FOREIGN TAX PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **D. Special Tax Provisions for U.S. Persons** | | | | |
| **1. Possession tax credit** | | | | |
| ***a. Income-based credit*** | (a) U.S. corporations meeting certain requirements are allowed to claim an income tax credit for U.S. tax on U.S. possession source income. Similar rules apply to the U.S. Virgin Islands.<br>To qualify, at least 80 percent of a possession subsidiary's income must be derived from the possessions, and no more than 35 percent of the income may be from passive investments.<br>The possession tax credit is not allowed with respect to income generated from intangibles transferred to the possessions unless the taxpayer elects one of two optional methods of allocating intangible income: (1) the cost sharing method or (2) the 50/50 profit split method. The cost sharing payment need not be as great as an arm's-length royalty.<br>The two intangible income allocation methods are not allowed for any product unless (1) at least 25 percent of the value added to the product is a result of economic activity in the possessions, or (2) at least 65 percent of the direct labor cost for the product is incurred in the possessions.<br>Income must be received in the possessions to be eligible for the credit. | (a) The possession tax credit would be repealed, subject to a 5-year transition rule, and replaced with a tax credit based on wages paid by manufacturing establishments in the possessions (including the U.S. Virgin Islands) described at c., below.<br>*Effective date.*—Under a transition rule, corporations could elect to continue to use the present tax credit for 5 years, beginning with the first taxable year ending after 1985, with respect to possession source income from products that were manufactured or validly designated during the taxable year beginning in 1985. | (a) Retain present law except: (1) Under the cost sharing method, the cost sharing payment is equal to the greater of (a) 110 percent of the payment under present law and (b) the royalty payment that would be required with respect to manufacturing intangibles if the possession corporation were treated as a foreign corporation; (2) under the profit split method, the amount of product area research expenditures would be increased by 20 percent for purposes of computing combined taxable income; (3) the passive income limitation would be reduced to 25 percent; and (4) the credit would be allowed for otherwise eligible income received in the U.S.<br>*Effective date.*—Generally taxable years beginning after 1985. Under a transition rule, the passive income limitation would be phased down to 30 percent for taxable years beginning in 1986, and to 25 percent for taxable years beginning in 1987. | (a) Same as House bill, except that royalty payment amount is determined under present law arm's-length standards.<br>*Effective date.*—Generally, taxable years beginning after 1986. The passive income limitation would be 25 percent for taxable years beginning in or after 1987. |
| ***b. Qualified Possession Source Investment Income (QPSII)*** | (b) Investment income eligible for the possessions tax credit (i.e., QPSII) must be derived from investment within a possession in which the taxpayer conducts an active trade or business. | (b) No provision. | (b) QPSII would include income attributable to loans made by the Government Development Bank of Puerto Rico (GDB) for the acquisition or construction of active business assets in qualified Caribbean Basin Initiative (CBI) countries.<br>*Effective date.*—January 1, 1986. | (b) Same as House bill.<br>*Effective date.*—Taxable years beginning after 1986. |

## X. FOREIGN TAX PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| *c. Wage credit* | (c) No provision. | (c) The credit for wages paid by manufacturing establishments in the possessions would equal 60 percent of wages up to the Federal minimum wage (currently $6,968 on an annual basis), plus 20 percent of wages in excess of the minimum wage, up to four times the minimum wage ($24,872 per annum). The maximum credit would be 120 percent of the minimum wage ($8,361.60 per annum). Wages that are credited would not be deductible from gross income. The wage credit would not be refundable, but could be carried forward 15 years and used to reduce tax on income from outside the possessions.<br>U.S. companies that elect the wage credit would be subject to the following rules: (1) possession taxes would not be eligible for the foreign tax credit, but instead would be deductible; (2) all income would be taxed currently; (3) dividends paid by possession corporations to U.S. affiliates would be treated as U.S. corporate dividends (eligible for the dividend-received deduction); and (4) property used in the possessions would be eligible for incentive depreciation (CCRS).<br>*Effective date.*—The wage credit would be available for taxable years beginning after 1985. | (c) Retain present law. | (c) Retain present law. |

## X. FOREIGN TAX PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **2. Other rules with respect to U.S. possessions** | | | | |
| ***a. U.S. Virgin Islands*** | (a)(1) The U.S. Virgin Islands (like Guam, the Commonwealth of the Northern Mariana Islands, and Samoa (see b., below)) generally uses the Code as it changes from time to time as its local tax code. For corporate tax purposes, the United States treats each of these possessions as a foreign country and each of these possessions treats the United States as a foreign country. This system of taxation has acquired the name "mirror system" because the possession uses the Code (but substitutes its own name for the United States and, for some purposes, treats the United States as the United States treats a possession). | (a)(1) In general, clarify the operation of the U.S. Virgin Islands' mirror system to prevent unintended results. Treat any bona fide V.I. resident on the last day of the taxable year as taxable only in the Virgin Islands, and not in the United States. A U.S. individual (other than a V.I. resident) who derives income from the Virgin Islands would file two identical returns, one with the United States and one with the Virgin Islands, and would pay a pro rata amount of tax to each. Provide for cooperation between the IRS and the Virgin Islands Bureau of Internal Revenue. | (a)(1) Same as President's proposal.* | (a)(1) Same as President's proposal. |
| | (2) The Virgin Islands may impose a surtax of up to 10 percent on the mirror tax. The Virgin Islands can rebate its mirror tax on its resident individuals and on U.S. and V.I. corporations that operate primarily in the Virgin Islands. | (2) Permit the Virgin Islands to impose any nondiscriminatory local income taxes in addition to those it now imposes under the mirror system. Permit the Virgin Islands to rebate tax on U.S. corporations whatever the extent of their activities in the Virgin Islands. Consider authorizing the Virgin Islands to reduce or rebate V.I. tax on some foreign persons' V.I. income. | (2) Same as President's proposal, and allow reduction of V.I. tax on V.I. income of foreign persons. | (2) Same as House bill. |

---

*Due to clerical error, the House-passed version of these rules is not contained in the bill. It may be found in the *Congressional Record* of December 10, 1985, at page H11721.

## X. FOREIGN TAX PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| ***a. U.S. Virgin Islands (Cont.)*** | (3) An "inhabitant" of the Virgin Islands pays tax to the Virgin Islands on its worldwide income, but pays no U.S. tax. Certain corporations qualify for inhabitant status, including some U.S. corporations. | (3) Repeal the V.I. inhabitant rule. | (3) Same as President's proposal. | (3) Same as President's proposal. |
| | (4) A V.I. corporation is not subject to the U.S. 30-percent withholding tax on passive income so long as it meets criteria designed to prevent the use of V.I. corporations as conduits for third-country residents: the V.I. corporation must be less than 25 percent foreign-owned and earn at least 20 percent of its income from V.I. sources. | (4) Amend the rules that prevent foreigners from using V.I. corporations as conduits to avoid the U.S. 30-percent withholding tax by substituting a requirement that 65 percent of a corporation's income be effectively connected with a trade or business in a possession or in the United States, in place of the 20-percent source of income requirement in current law. | (4) Same as President's proposal. | (4) Same as President's proposal. |
| | | *Effective date.*—Taxable years beginning after 1985. | *Effective date.*—Generally, same as President's proposal, but certain provisions are contingent upon implementation of a U.S.-V.I. agreement to coordinate the U.S.-V.I. tax systems. | *Effective date.*—Generally same as House bill, except that repeal of the V.I. inhabitant rule would apply to all open years. If an implementing agreement is not in place within one year after enactment, Treasury shall report on the status of negotiations. |
| ***b. Guam, the Northern Mariana Islands, and American Samoa*** | (b)(1) U.S. law requires that Guam use the Code as its local tax code. (See general description of the mirror system of taxation at a., above.) Individual residents of the United States or Guam need file a tax return only with the place where they resided on the last day of the year. Guamanian corporations are not subject to the U.S. 30-percent withholding tax, except Guamanian corporations that foreign persons may use as conduits (under the rules that apply to V.I. corporations). The Commonwealth of the Northern Mariana Islands (CNMI) is required to use the mirror system in basically the same way as Guam. The latter treatment generally began on January 1, 1985. | (b)(1) Grant Guam and the CNMI full authority to determine their own income tax laws. This treatment would place them on a par with American Samoa. Require that Guam and the CNMI implement tax systems that would raise at least as much revenue as their current mirror systems. Residents of Guam and the CNMI who received income from outside those possessions would have to file U.S. tax returns. The United States would collect the tax on that non-possession income, but would transfer the money to the possession where the taxpayer resided. For the purpose of the U.S. 30-percent withholding tax, the proposal would modify the anti-conduit rule for Guam and the CNMI in the same way as proposed for the Virgin Islands. | (b)(1) Same as President's proposal. | (b)(1) Same as President's proposal. |
| | (2) Interest income on U.S. obligations held by the Bank of Guam is treated as effectively connected with the conduct of a U.S. trade or business. | (2) No provision. | (2) Provide that interest income on U.S. Government obligations held by the Bank of Guam will be treated as not effectively connected with the conduct of a U.S. trade or business. | (2) Same as House bill. |

BEST COPY AVAILABLE

## X. FOREIGN TAX PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| ***b. Guam, the Northern Mariana Islands, and American Samoa (Cont.)*** | (3) American Samoa has adopted its own income tax system. American Samoa has chosen to use the Code, with minor amendments, as its internal income tax system. | (3) For American Samoa (as well as for Guam and the CNMI), implement anti-abuse provisions to prevent the use of corporations in these possessions to avoid U.S. tax. Coordinate taxes among these possessions and exchange information between each possession and the United States. Each possession would receive taxes withheld on compensation of U.S. Government personnel stationed there. | (3) Same as President's proposal. | (3) Same as President's proposal. |
| | | *Effective date.*—Generally, January 1, 1986. The mirror codes of Guam and the CNMI would continue to operate until and except to the extent that each possession took action to amend its own laws. | *Effective date.*—Taxable years beginning after 1985, but only if (and so long as) an agreement is in effect between a possession and the United States to coordinate the U.S. and possession tax systems. The provision concerning Bank of Guam is effective for taxable years beginning after November 16, 1985. | *Effective date.*—Same as House bill. If an implementing agreement is not in place within one year after enactment, Treasury shall report on the status of negotiations. |
| **3. Taxation of U.S. employees of Panama Canal Commission** | (a) An agreement between the United States and Panama entered into in conjunction with the Panama Canal Treaty specifies the rights and legal status of agencies and employees of the U.S. Government operating in Panama. One article of the agreement provides an exemption from tax for U.S. employees of the Panama Canal Commission. In a diplomatic note, Panama has confirmed the United States' explanation that the exemption was intended to apply solely to Panamanian taxes. Courts have split on the question whether the exemption applies to U.S. taxes. | (a) None. | (a) Clarify that the Agreement in Implementation of the Panama Canal Treaty does not exempt U.S. taxpayers from U.S. tax. | (a) Same as House bill. |
| | | | *Effective date.*—All open taxable years. | *Effective date.*—Taxable years beginning on or after January 1, 1987. |
| | (b) Overseas employees of the U.S. government are permitted to exclude certain allowances from gross income for U.S. tax purposes. Allowances paid to U.S. employees of the Panama Canal Commission are not presently excludable under this rule. | (b) None. | (b) Provide that U.S. government employees of the Panama Canal Commission may exclude allowances equivalent to those permitted to be excluded by State Department employees in Panama. | (b) Same as House bill. |
| | | | *Effective date.*—Taxable years beginning after 1985. | *Effective date.*—Taxable years beginning after 1986. |

## X. FOREIGN TAX PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| 4. Foreign Sales Corporation (FSCs) | The United States limits its tax on qualified income from exports when the exporter uses a "FSC"—a Foreign Sales Corporation. The FSC rules reduce taxable income by 16 percent of export income (15 percent for corporate shareholders). The Domestic International Sales Corporation (DISC) rules provide a similar benefit but only on the income from $10 million in export sales. | None. | Change FSC rules to exempt 14 percent of export income (13 percent for corporate shareholders). Make corresponding changes to DISC rules.<br>*Effective date.*—Generally, taxable years beginning after 1985. | Retain present law. |
| 5. Private sector earnings of Americans abroad | U.S. citizens (other than U.S. Government employees) who live and work abroad and who satisfy certain physical presence or bona fide foreign residence tests may exclude from gross income their foreign earned income up to $80,000 per year, and may also exclude their foreign housing costs that exceed a base amount. The $80,000 ceiling on excludable foreign earned income is scheduled to increase $5,000 each year beginning in 1988, up to $95,000 for taxable years beginning in or after 1990. This schedule reflects a Deficit Reduction Act of 1984 freeze of the increases, which the Economic Recovery Tax Act of 1981 had scheduled to begin in 1984. | None. | Reduce the foreign earned income exclusion ceiling to $75,000.<br>*Effective date.*—Taxable years beginning after 1985. | Retain present law. |
| 6. Transfers of intangibles to related parties outside of the U.S. | Transfers to related foreign corporations as licenses or sales are subject to an "arm's-length" price standard. Uncertainty exists regarding what transfers are appropriate to treat as "arm's-length" comparables and regarding the significance of profitability, including major changes in profitability of the intangible after the transfer.<br>Transfers to related foreign corporations as contributions to capital require the transferor to recognize annually, as U.S. source income, amounts that would have been received under an agreement providing for payments contingent on productivity, use, or disposition of the property.<br>Special rules apply for transfers to related U.S. possessions corporations (see Possessions Tax Credit, above). | No provision. | Payments with respect to intangibles transferred to a foreign related party must be commensurate with the income attributable to the intangible. This standard also applies to determine the minimum payment with respect to intangibles transferred to a related U.S. possessions corporation that elects the cost-sharing option.<br>*Effective date.*—For transfers from U.S. persons to foreign related parties, the bill applies to transfers after November 16, 1985 in taxable years ending after that date.<br>For transfers to U.S. possessions corporations that elect the cost-sharing option, the bill applies for taxable years beginning after December 31, 1985. | Retain present law. |

## X. FOREIGN TAX PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **7. Compliance provisions applicable to U.S. persons resident abroad.** | U.S. persons resident abroad are required to file U.S. tax returns, but a substantial percentage of foreign residents fails to do so.<br>(a) Failures to file are often difficult to detect because IRS lacks information concerning foreign residents. IRS formerly obtained some information from voluntary information returns filed with passport applications, but the return was discontinued because many taxpayers refused to file a voluntary return.<br>(b) Even when overseas non-filers are identified, enforcement is often difficult because IRS cannot collect tax in foreign countries, and must instead attempt to locate assets within the United States. U S. pension payments to foreign residents, like all U.S. pension payments, are not subject to a withholding tax such as that which applies to wage and salary payments. | (a) No provision.<br>(b) No provision. | (a) No provision.<br>(b) No provision. | (a) Require that passport applicants (including renewal applicants) complete an IRS information return disclosing foreign residence. Penalties for failure to file would apply.<br>*Effective date.*—Taxable years beginning after 1986.<br>(b) Require withholding with respect to pension payments to U.S. persons living outside the United States.<br>*Effective date.*—Taxable years beginning after 1986. |
| **8. Foreign investment companies** | Generally, no current U.S. tax applies to the foreign income of a foreign corporation that is not a controlled foreign corporation (under subpart F) or a foreign personal holding company (under the FPHC rules) even if all its income is passive income or other tax haven income, and even if all its shareholders are Americans.<br>When a U.S. person disposes of stock in a foreign investment company (FIC), however, the gain is not automatically subject to a favorable capital gains tax rate, even if the company is widely held. The gain is subject to ordinary income treatment to the extent of the shareholder's share of the FIC's earnings and profits. This special ordinary income rule generally applies to a foreign corporation that is primarily in the business of investing in securities or commodities, if 50 percent or more of the corporation's stock (by vote or value) is held by U.S. persons. | No provision. | Amend the FIC rules as follows:<br>(1) Apply the FIC rules to U.S. investors in foreign funds without regard to the degree of U.S. ownership of such funds;<br>(2) Require current recognition of income by U.S. investors in FICs that are passive-investment vehicles, by looking through to the FIC's earnings and profits;<br>(3) Allow U.S. persons to defer tax upon agreement to pay tax plus interest on disposition of the investment;<br>(4) Liberalize the FIC rules to allow credits for foreign tax paid by a corporation that is both a FIC and a controlled foreign corporation; and<br>(5) The bill would apply to FICs that had elected to distribute income currently (under sec. 1247).<br>*Effective date.*—Generally, taxable years of foreign corporations beginning after 1985. | Amend the FIC rules as follows:<br>(1) Retain present law for U.S. investors in FICs defined in section 1246;<br>(2) Impose interest charge based on value of deferral for U.S. investors that invest in passive-investment vehicles (whatever the degree of U.S. ownership);<br>(3) Allow election to pay tax currently. For U.S. persons that pay tax currently, allow income earned by fund to retain its character (as capital gain or ordinary income) at shareholder level;<br>(4) Same as House bill; and<br>(5) The proposal would exempt FICs that had elected to distribute income currently (under sec. 1247).<br>*Effective date.*—Amounts received or accrued by foreign corporations on or after January 1, 1987. |

## X. FOREIGN TAX PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **E. Foreign Taxpayers**<br>1. Branch-level tax | Foreign corporations are subject to U.S. corporate-level tax on income effectively connected with a U.S. trade or business. A shareholder-level tax also is imposed on some foreign corporate earnings: a 30-percent gross withholding tax applies to a pro rata portion of dividends paid by a foreign corporation if more than 50 percent of the corporation's income over a three-year period is effectively connected with a U.S. trade or business. A similar withholding tax applies to interest payments by foreign corporations. The withholding taxes are reduced or eliminated under a number of U.S. tax treaties. Some countries substitute a branch-level tax for a direct shareholder-level tax on domestic source earnings of foreign corporations. | Repeal the withholding taxes on dividends and interest paid by foreign corporations. Replace the dividend tax with a tax on remitted profits of U.S. branches of foreign corporations. Replace the interest tax with a tax on foreign corporations' interest payments that are allocable to U.S. branch operations. In both cases, tax would be imposed at a 30-percent rate, or at any lower treaty rate that would apply to direct-investment dividends paid to the foreign corporation. Tax would not be imposed when existing U.S. treaties prohibit a tax on branch profits—some argue that a number of existing treaties do so.<br>*Effective date.*—Taxable years beginning after December 31, 1985. | Generally follows President's proposal, overriding treaties to the extent they allow treaty-shopping. In the case of countries with treaties that now allow a U.S. withholding tax, but not the branch profits tax, retain present law. Allow a credit against a U.S. company's U.S. tax for any branch level tax imposed on a foreign corporation owned by the U.S. company on receipt of a dividend from the foreign corporation.<br>*Effective date.*—Generally, taxable years beginning after 1985. | Generally follows President's proposal, overriding treaties to the extent they allow treaty shopping. In the case of countries with treaties that now allow a U.S. withholding tax, but not the branch tax, retain present law (unless treaty shopping occurs, in which case impose the withholding tax).<br>*Effective date.*—Taxable years beginning after 1986. |
| 2. Retain character of effectively connected income | The United States taxes foreign persons' income that is effectively connected with a U.S. trade or business on a net basis at graduated rates, in the same manner that it taxes the income of U.S. persons. Foreign persons may not be subject to U.S. tax if they receive income that was earned by a U.S. trade or business in a year after the trade or business has ceased to exist (e.g., by selling property and recognizing the gain on the installment basis). | None. | Provide that income or gain will be treated as effectively connected with a U.S. trade or business if it is attributable to another taxable year and would have been so treated if it had been taken into account in that other year.<br>*Effective date.*—Taxable years beginning after 1985. | Same as House bill, but treat the removal of business assets from U.S. jurisdiction as a disposition, with basis step-up for business assets brought into the United States.<br>*Effective date.*—Taxable years beginning after 1986. |
| 3. Tax-free exchanges by expatriates | A U.S. citizen who gives up citizenship for a principal purpose of avoiding U.S. tax will generally continue for a period of ten years to be taxed as a citizen on U.S. source income, but not foreign source income. U.S. source income for this purpose includes gains from sales of U.S. property. Tax-avoidance expatriates may be able to avoid tax by making a tax-free exchange of U.S. property for foreign property. | None. | Apply the tax-avoidance expatriate rules to gains on the sale of property the basis of which was determined by reference to property located in the United States, stock of a U.S. corporation, or a debt obligation of any U.S. person.<br>*Effective date.*—The rule would apply to sales of property acquired in tax-free exchanges after September 25, 1985. | Same as House bill.<br>*Effective date.*—The rule would apply to sales of property acquired in tax-free exchanges after March 1, 1986. |

## X. FOREIGN TAX PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **4. Excise tax on insurance premiums paid to foreign insurers** | The United States imposes excise taxes on premiums paid for the direct insurance or reinsurance of U.S. risks to foreign entities not doing business in the United States. The rates are (per dollar of premium): four cents for casualty contracts, one cent for life contracts, and one cent for all reinsurance. The taxes are collected by return and liability falls jointly on all parties to the insurance transaction. Payments to some insurers are exempt by treaty, but reinsurance premiums paid by treaty-protected insurers are subject to the tax (unless the recipient is exempt by treaty).<br>The present "two-tax system"—one tax on the direct insurance of U.S. risk with a foreign insurer, and another, which generally is in addition to the first, on the reinsurance of a U.S. risk—is sometimes difficult to administer. Also, taxpayers may be able to structure insurance coverage for U.S. casualty risks so that only the lower tax on reinsurance premiums applies. | None. | Make the excise tax on casualty reinsurance premiums paid to foreign insurers for U.S. risk coverage equal to that on similar casualty insurance premiums (four percent). Impose an excise tax only once—on retained premiums received by foreign insurers or reinsurers. Make the foreign insurer (or his agent) liable for the tax and require the U.S. insured or broker obligated to transmit the premiums to withhold the tax.<br>*Effective date.*—The tax would apply to premiums paid after December 31, 1985. | Retain present law. |
| **5. Foreign investment in U.S. business assets** | | | | |
| ***a. Foreign Investment in Real Property Tax Act (FIRPTA)*** | (a) The United States taxes income of foreign persons that is effectively connected with a U.S. business. The United States generally also taxes gains of foreign persons only on the disposition of U.S. real property interests (including stock in U.S. real property holding companies). However, gains on most dispositions of U.S. corporate stock, including sales of subsidiaries and sales of shares in closely held corporations, are not generally taxed by the United States. | (a) No provision. | (a) No provision. | (a) In general, extend the rules that tax dispositions by foreign persons of stock in U.S. real property holding companies to dispositions by foreign persons of stock in other U.S. companies. |
| ***b. Exclusion from FIRPTA for de minimis ownership in publicly traded corporate stock*** | (b) Gain or loss from the disposition by a foreign person with 5 percent or less of stock ownership of stock that is regularly traded on an established securities market is not treated as a disposition of a U.S. real property interest. | (b) No provision. | (b) No provision. | (b) Exclude from the new tax dispositions of stock that are regularly traded on established securities markets unless the foreign person holds more than 5 percent of the class of stock at issue. |

## X. FOREIGN TAX PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **5. Foreign investment in U.S. business assets (Cont.)** | | | | |
| ***c. Collection of FIRPTA tax*** | (c) Withholding rules are provided to collect U.S. tax due from the disposition by foreign persons of U.S. real property interests. | (c) No provision. | (c) No provision. | (c) Adopt the present law withholding provisions for the collection of the tax on foreign persons' gains on the disposition of U.S. real property interests for this purpose. |
| ***d. Gain on the liquidation of U.S. corporations*** | (d) With limited exceptions (for example, certain recapture items), the United States does not tax corporations on distributions of appreciated property in complete liquidation. | (d) No provision. | (d) No provision. | (d) Tax gains on liquidations of foreign-controlled U.S. corporations and distributions in liquidation of U.S. trade or business assets of foreign corporations. |
| ***e. Shared-appreciation and participating loans*** | (e) Present law is unclear regarding to what extent the receipt of a debt payment that is contingent on appreciation of taxable property constitutes a taxable disposition of the property (rather than an interest payment). | (e) No provision. | (e) No provision. | (e) Clarify that a payment of interest contingent on appreciation of property whose disposition by the recipient would be taxable constitutes a taxable disposition of the property. |
| ***f. Treaty interaction*** | (f) FIRPTA overrides U.S. income tax treaties as of January 1, 1985. | (f) No provision. | (f) No provision. | (f) This new capital gains tax would yield to treaties when the foreign transferor is a bona fide treaty country resident.<br>*Effective date.*—Taxable years beginning after 1986. |
| **6. Withholding tax on interest paid to foreign persons** | The United States taxes the worldwide income of U.S. persons on a net basis. The United States also taxes on a net basis income of foreign persons that is effectively connected with a U.S. business. Some U.S. source investment income of foreign persons, including certain interest, that is not effectively connected with a U.S. business is subject to a flat 30-percent U.S. withholding tax. The law provides a number of exemptions from this tax for interest: for example, portfolio interest, interest paid on U.S. bank deposits, original issue discount on short-term obligations, and income of foreign governments from passive investments in the United States. Also, many U.S. income tax treaties reduce or eliminate the withholding tax on interest. | No provision. | No provision. | Impose a 5-percent withholding tax on interest paid and original issue discount accrued by U.S. persons with respect to obligations held by foreign persons that are issued after the date of enactment. Exempt from the tax interest paid on bank account deposits, and interest paid to foreign central banks. Retain present law for interest subject to the existing statutory withholding tax at either the full 30-percent rate or at a reduced treaty rate, to the extent that any reduced treaty rate exceeds the rate of the new tax. Until 1992, the new tax would yield to treaties when the foreign holder of the obligation is a bona fide treaty country resident. After 1991, bona fide treaty country residents would be taxable.<br>*Effective date.*—Interest paid on obligations issued after date of enactment. |
| **7. Reporting by foreign-controlled U.S. corporations** | Foreign-controlled U.S. corporations are required to report transactions with related foreign corporations. | No provision. | No provision. | Require foreign-controlled U.S. entities to report transactions with all related foreign persons, whether or not a corporation.<br>*Effective date.*—Taxable years beginning after 1986. |

## X. FOREIGN TAX PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **8. Foreign investors in U.S. partnerships** | Foreign persons who earn wages or investment income in the United States are generally subject to withholding requirements designed to ensure collection of applicable U.S. taxes. Foreign persons with investments in U.S. partnerships, however, are not subject to a withholding tax. | No provision. | No provision. | Require that domestic partnerships withhold with respect to all income allocable to foreign partners.<br>*Effective date.*—Taxable years beginning after 1986. |
| **9. Income of foreign governments** | Foreign governments are not subject to U.S. tax on income from their investments in the United States. Treasury regulations specify that income from commercial activities is not investment income and therefore is not exempt from U.S. tax. | No provision. | No provision. | Codify the rule taxing the commercial activities of foreign governments, and define commercial activity to include ownership of a controlling interest in a corporation engaged in trade or business in the United States. Clarify that the determination of whether a government is engaged in commercial activities is to be made by reference to its activities worldwide. The foreign government exception would not apply to controlled entities that engage in any commercial activities.<br>*Effective date.*—Taxable years beginning after 1986. |
| **10. Transfer prices for imports (sec. 482)** | Importers may claim a transfer price for customs purposes that is too low to be consistent with the transfer price they claim for income tax purposes. (See Brittingham 66 T.C. 373; 79-2 USTC 9494). | Retain present law. | Retain present law. | Importers could not claim a transfer price for income tax purposes that is higher than would be consistent with the value they claim for customs purposes.<br>*Effective date.*—Transactions entered into after March 18, 1986. |
| **11. Dual resident companies** | U.S. corporations that are "residents" of foreign countries may consolidate with profitable companies both here and abroad and obtain for related parties two deductions for one item of expense. | No provision. | No provision. | Do not allow a U.S. corporation to consolidate with other U.S. corporations if related foreign parties benefit from its losses through foreign consolidation or group relief rules, unless its common parent is part of the U.S. consolidated group.<br>*Effective date.*—Taxable years beginning after 1986. |
| **12. Interest paid to related tax-exempt parties.** | Certain taxpayers may unduly reduce their tax by deducting interest paid or accrued to related parties who do not pay U.S. tax on the interest income. | No provision. | No provision. | Deny the deduction for interest paid or accrued to related, tax-exempt parties (other than ESOPs) to the extent interest exceeds 50 percent of preinterest deduction taxable income. This restriction would also apply to back-to-back loans that might otherwise defeat the purpose of this rule. |

## X. FOREIGN TAX PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **F. Foreign Currency Exchange Gain or Loss** | | | | |
| **1. Foreign currency transactions** | | | | |
| ***a. Functional currency concept*** | (a) For financial reporting purposes, the "functional currency" of a business entity—the currency of the economic environment in which it operates—is used as the reference point in determining exchange gains and losses. The functional currency concept is not embodied in present law. | (a) Similar to the financial accounting rules, the determination of whether exchange gains or losses must be recognized on a transaction-by-transaction basis, or in the aggregate on an annual basis, would be determined on the basis of a business entity's functional currency. | (a) Same as President's proposal. | (a) Same as President's proposal. |
| ***b. Recognition of gain or loss on financial assets and liabilities*** | (b) In many instances, present law is unclear regarding the timing of recognition of exchange gains or losses derived from foreign currency denominated financial assets or liabilities. | (b) For financial assets or liabilities denominated in a currency other than an entity's functional currency, exchange gain or loss would arise if the exchange rate fluctuates between the date the item is taken into account for tax purposes and the date it is paid. | (b) Same as President's proposal. | (b) Same as President's proposal; it would be clarified that exchange gain or loss arises on the settlement or other disposition of foreign currency forward or futures contracts or similar contracts that can be used to hedge that are not marked-to-market under section 1256. |
| ***c. Current accrual of anticipated exchange gain or loss*** | (c) No provision. | (c) For a financial asset or liability that provides for fixed or determinable payments, "anticipated" exchange gain or loss would be accrued currently, under rules similar to the present-law rules that test the adequacy of interest on installment obligations by reference to the yield on U.S. Government securities. | (c) To the extent provided in regulations, exchange gain or loss would be currently accrued in the case of certain hedging transactions. | (c) Same as House bill, but add a statutory rule to prevent overstatement of deductions. |
| ***d. Character*** | (d) No provision. | (d) All exchange gain or loss would be treated as an increase or decrease in interest income or expense. | (d) Exchange gain or loss would be treated as interest income or expense, except as provided by statute or regulations. | (d) Same as President's proposal, except as provided in regulations. |
| ***e. Hedging transactions*** | (e) No provision. | (e) Exchange gain or loss on a contract that offsets the risk of exchange rate fluctuations with respect to a financial asset or liability would be recognized on an accrual basis, and characterized and sourced consistent with the treatment of the hedged item. | (e) The scope of the hedging rule for exchange gain or loss and the hedging exemption under the tax straddle rules would be conformed, without a special rule for banks for either purpose. | (e) Same as House bill, except it would be clarified that the hedging rule for exchange gain or loss does not require that the transaction be entered into in the normal course of business and generate only ordinary income or loss. |
| **2. Foreign currency translation** | | | | |
| ***a. Translation method*** | (a) The Code does not prescribe rules for determining when and how the results of foreign operations involving transactions in foreign currencies are to be reported for U.S. tax purposes. The taxpayer may choose among several recognized methods of translating results of foreign operations, which methods may produce substantially different U.S. tax consequences. | (a) A business entity that uses a functional currency other than the U.S. dollar would be required to use a profit-and-loss translation method. Generally, a single set of rules would be provided for branches and subsidiary corporations. | (a) Same as President's proposal. | (a) Same as President's proposal. |

## X. FOREIGN TAX PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| *b. Branch remittances and losses* | (b) When a foreign branch remits currency in excess of the current year's profit, the basis of the excess amount must be determined in order to calculate exchange gain or loss. Present law is unclear regarding the allocation of remittances between previously-taxed earnings and contributions to branch capital, and whether capital is fully recovered before any exchange gain or loss is recognized. | (b) Exchange gain or loss on remittances in excess of current profits would be recognized in a manner that is analogous to the treatment of cash distributions from a partnership. A taxpayer's dollar basis in a foreign branch would be recovered before exchange gains or losses on remittances would be recognized. | (b) Exchange gain or loss would be recognized on remittances, determined by assuming that remittances are made on a pro rata basis out of prior years' earnings, and would be treated as separate basket foreign-source income. Rules would be provided to preclude a deduction for branch losses in excess of a taxpayer's U.S. dollar investment in the foreign branch. | (b) Same as House bill, except exchange gain or loss on remittances would not be treated as separate basket foreign-source income or allocated to such income. Instead, except as provided in regulations, it would be treated as U.S. source. |
| *c. Direct foreign tax credits* | (c) For foreign taxes paid on income derived directly (e.g., through a branch), taxpayers generally translate the taxes at the exchange rate on the date paid. Adjustments to a foreign tax are translated at the exchange rate in effect on the date of adjustment. | (c) A redetermined foreign tax would be translated at the exchange rate in effect on the payment date. | (c) A refund would be translated at the exchange rate in effect when the tax was originally paid. Other adjustments would be translated at the rate in effect on the date of the adjustment. | (c) Same as House bill, except a tax and a refund of that tax would be translated at the weighted average exchange rate applicable to earnings for the year in which the tax was originally paid or accrued. |
| *d. Indirect foreign tax credits* | (d) A tax credit is allowed to U.S. corporations for foreign taxes deemed paid with respect to dividends received from a foreign subsidiary, and with respect to deemed distributions of Subpart F income. The amount of the indirect credit is determined under a formula that takes into account the foreign taxes paid by the subsidiary, the amount of the dividend, and the subsidiary's earnings and profits ("E&P").<br>For this purpose, foreign taxes and the amount of the dividend are generally translated at the exchange rate on the date of receipt, under case law. Foreign taxes deemed paid with respect to Subpart F income are translated at an average rate for the period in which the income was earned by the foreign subsidiary. In the case of an actual distribution, E&P are translated at the exchange rate in effect on the date of distribution. In the case of a Subpart F dividend, E&P are translated at an average exchange rate for the year, adjusted to reflect unrealized exchange rate gains and losses. | (d) The indirect foreign tax credit would be computed by using a common exchange rate (the rate on the date of distribution, or the average exchange rate for the year in the case of a deemed distribution) for the distribution or deemed distribution, earnings and profits, and foreign taxes. | (d) Foreign taxes would be translated at the rate in effect on the date actually paid or accrued by the subsidiary rather than the current rate. Exchange gain or loss with respect to the earnings distributed (based on the historic rate for the year earned) would be treated as separate basket foreign-source income. Adjustments would be subject to the same rules that apply for purposes of the direct credit (see 2.c., above). | (d) Same as President's proposal. |
| 3. Effective date | | *Effective date.*—Generally, for taxable years beginning after January 1, 1986. For transactions, the proposals would be effective for financial assets acquired or liabilities incurred after January 1, 1986. | *Effective date.*—Taxable years beginning after 1985. | *Effective date.*—Generally for taxable years beginning after 1986. |

# XI. INSURANCE PRODUCTS AND COMPANIES

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **A. Insurance Products**<br>**1. Life insurance products** | | | | |
| ***a. Inside buildup*** | (a) The cash value of a life insurance policy earns interest ("inside buildup") that is credited to the account of the policyholder and is not taxed as current income to the policyholder. This income is never taxed if the proceeds of the policy (including income credited to the policy) are paid to the policy's beneficiary after the death of the insured.<br>Taxation of the inside buildup is only deferred to the extent that a policy is not cashed in (or surrendered) in exchange for its cash surrender value. | (a) A life insurance policyholder would annually include in income any increase in the excess of the policy's cash surrender value over the investment in the contract during the taxable year.<br>Policyholders with variable life insurance policies would be taxed on a proportionate share of realized gains and other income earned on assets of the separate account underlying the variable policy.<br>*Effective date.*—The proposal would be effective after December 31, 1985, for inside buildup credited to policies issued on or after the date of committee action. For policies issued before the date of committee action, inside buildup would continue to be exempt from tax to the extent the death benefit is not increased above the sum of the death benefit on the date of committee action and any additional death benefit required for the policy to continue to qualify as a life insurance contract for purposes of Federal tax law. | (a) Retain present law. | (a) Retain present law. |
| ***b. Policyholder loans and partial withdrawals*** | (b) Life insurance policies often permit the policyholder to borrow up to the cash surrender value of the policy. Until repaid, the policyholder loan reduces the proceeds payable to the policyholder in the event of a surrender of the policy or to the beneficiaries in the event of the death of the policyholder.<br>Under present law, policyholder loans generally are treated as loans and not as withdrawals from the policy. Interest paid on policyholder loans generally is deductible by the policyholder even though the policy's inside buildup has not been included in taxable income.<br>No deduction is allowed for amounts paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance contract. | (b) The President's proposal did not recommend any specific changes relating to the tax treatment of policyholder loans. However, the President's proposal would generally limit the deduction for nonbusiness interest to the sum of net investment income, interest on debt secured by the taxpayer's principal residence (up to its value), and $5,000.<br>*Effective date.*—The nonbusiness interest limitation generally would be effective (subject to two phase-in rules) for interest expense paid or incurred after December 31, 1985. | (b) Restates present-law rule that no amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance contract is deductible. | (b) Retain present law. |
| ***c. Exclusion for interest on installment payments of life insurance proceeds*** | (c) A beneficiary of a life insurance policy may receive installment payments of the proceeds of the policy. Amounts in the nature of interest (up to $1,000 annually) on the unpaid proceeds of the policy paid to the surviving spouse of the insured are not included in the spouse's income. | (c) None. | (c) Repeals the $1,000 annual exclusion for the amounts in the nature of interest received by the surviving spouse of an insured.<br>*Effective date.*—The provision generally is effective after December 31, 1985. | (c) Same as House bill.<br>*Effective date.*—The provision generally would be effective after December 31, 1986. |

BEST COPY AVAILABLE

## XI. INSURANCE PRODUCTS AND COMPANIES—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **2. Other policyholder issues** | | | | |
| *a. Deduction for policyholder losses* | (a) A taxpayer generally may deduct a loss sustained during the taxable year and not compensated for by insurance or otherwise. If a casualty or other event occurs which results in a claim for reimbursement with respect to which there is a reasonable prospect of recovery (such as an insurance claim), then the loss may not be deducted until it can be ascertained with reasonable certainty that the reimbursement will not be received.<br>The casualty loss deduction is allowable only to the extent that the losses exceed 10 percent of the taxpayer's adjusted gross income (AGI). Some recent cases have held that the deduction is allowable when an individual has insurance coverage on nonbusiness property, but elects not to file a claim. | (a) Under the President's proposal, taxpayers suffering losses covered by insurance would be permitted to elect to claim a deduction with respect to those losses without regard to the prospect of recovery from the insurance company. Insurance proceeds would be taxable income when received to the extent of any portion of the loss that was previously deductible. Present law would continue to apply to nonelecting taxpayers.<br>*Effective date.*—The proposal would be effective for all losses incurred in taxable years beginning after December 31, 1985, that are insured under policies issued after December 31, 1985. | (a) Retains present law, but the casualty loss deduction is denied to the extent that an individual has insurance coverage on nonbusiness property and elects not to file a claim.<br>*Effective date.*—The provision is effective for taxable years beginning after December 31, 1985. | (a) Retain present law. |
| *b. Structured settlements* | (b) Present law excludes from income the amount of any damages received on account of personal injuries or sickness, whether by suit or agreement and whether as a lump sum or as periodic payments. The person liable to pay the damages may assign to a third party (a structured settlement company) the obligation to pay the periodic payments. The portion of the amount received by that third party for agreeing to the assignment that is used to purchase assets to fund the liability is not included in the third party's income.<br>The overall effect of these rules is that no taxpayer is subject to tax on the investment income earned on assets used to fund the periodic payment of damages for personal injuries. | (2) Under the President's proposal, third-party assignees of liabilities to make periodic personal injury damage payments would include the full amount of consideration received from the assignor in gross income. An assignee purchasing an annuity contract to fund its liabilities to an injured party would be treated as the owner of the annuity and would be taxed on the income component of all amounts paid to it under the terms of the annuity contract. The assignee would be given an election concerning the tax treatment (i.e., the timing of its deduction).<br>*Effective date.*—The proposal would be effective for all assignments entered into after December 31, 1985. | (b) Retains present law, but limits the exclusion for structured settlement agreements to cases involving physical injury or sickness.<br>*Effective date.*—Same as President's proposal. | (b) Same as President's proposal.<br>*Effective date.*—The provision would be effective for all assignments entered into after December 31, 1986. |

## XI. INSURANCE PRODUCTS AND COMPANIES—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **B. Life Insurance Companies** | | | | |
| **1. Reserves** | Life insurance companies generally are allowed a deduction for any net increase in reserves in a calendar year. The deduction for an increase in reserves takes into account increases due to both premiums and interest credited to the reserves. The net increase (or net decrease) in reserves is computed by comparing the closing balance to the opening balance for reserves in the same year.<br>For purposes of determining life insurance company taxable income, life insurance reserves for any contract are the greater of the net surrender value of the contract or the reserves determined under Federally prescribed rules. | Under the President's proposal, the reserve held for any life insurance contract would be limited generally to the net cash surrender value of the contract. Thus, a life insurance company would be allowed annually to add to its reserves, policy by policy, only the amount that the net cash surrender value increases.<br>In addition, the proposal would treat the reserves of life insurance companies (not included in life insurance reserves) in the same manner as the reserves of property and casualty companies. The QRA method (see the description in C.1., below) would apply for purposes of calculating a life insurance company's deduction for unpaid losses.<br>*Effective date.*—The proposal would be effective with respect to policies sold or losses incurred with respect to policies issued after December 31, 1985. | Retains present law. | Retain present law, but see the proposal relating to the treatment of unpaid loss reserves of life insurance companies attributable to accident and health business (item XI.C.I.c., below). |
| **2. Special deductions** | A life insurance company is taxed at corporate rates on its life insurance company taxable income (LICTI). A special life insurance company deduction and a small life insurance company deduction have the effect of reducing the tax rates imposed on LICTI. | | | |
| ***a. Small company deduction*** | (a) The small life insurance company deduction is 60 percent of tentative LICTI up to $3 million, and it is reduced by 15 percent of tentative LICTI that exceeds $3 million. The maximum deduction allowed is $1.8 million, and it phases out so that it becomes zero at $15 million of tentative LICTI. Only life insurance companies with gross assets of less than $500 million are allowed to take this deduction. | (a) Repeal the small company deduction. | (a) Retains present law. | (a) Retain present law. |
| ***b. Special life insurance company deduction*** | (b) A life insurance company is also allowed a special life insurance company deduction of 20 percent of its tentative LICTI (in excess of the small company deduction) for any taxable year. General corporate tax rates apply to LICTI after reduction by the deductions. | (b) Repeal the special deduction.<br>*Effective date.*—The proposal would be effective for taxable years beginning after December 31, 1985. | (b) Same as President's proposal.<br>*Effective date.*—Same as the President's proposal. | (b) Same as President's proposal.<br>*Effective date.*—The provision would be effective for taxable years beginning after December 31, 1986. |

## XI. INSURANCE PRODUCTS AND COMPANIES—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **3. Tax-exempt organizations engaged in insurance activities** | For certain tax-exempt organizations, the provision of insurance benefits to members or to the general public forms the basis for the organization's exemption from Federal income tax. | | | |
| | (a) A charitable organization directly engaged in providing insurance generally would be considered to be conducting a commercial activity which benefits a private, rather than public, interest and which would endanger the organization's tax exemption. Past IRS policy has permitted certain organizations, whose principal activities are providing life insurance, health insurance, and annuities to be treated as tax exempt. | (a) No provision. | (a) Under the bill, a charitable or social welfare organization is not entitled to tax-exempt status unless no substantial part of its activities consists of providing commercial-type insurance. Commercial-type insurance does not include (1) insurance provided at less than cost to a class of charitable recipients, (2) health insurance provided by a health maintenance organization that is incidental to the organization's principal activity of providing health care, and (3) property and casualty insurance (such as fire insurance) provided by a church or convention of churches solely for such church or convention. | (a) Retain present law. |
| | (b) An organization is entitled to tax exemption if it is operated exclusively for the promotion of social welfare. Some health insurance providers have been treated as tax-exempt social welfare organizations. | (b) No provision. | (b) Same as the rules for charitable organizations, except that the bill authorizes Treasury regulations with respect to the activities of Blue Cross and Blue Shield relating to high-risk individuals and small groups. | (b) Retain present law. |
| | (c) A fraternal beneficiary society, order, or association that is operating under the lodge system, and providing for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents is entitled to tax exemption. | (c) No provision. | (c) The bill requires a study of fraternal beneficiary societies by the Treasury Department to be reported to the Congress by January 1, 1988.<br>*Effective dates.*—The provision generally is effective for years beginning after December 31, 1985. A special rule provides that the provision does not apply with respect to the pension business of Mutual of America. A delayed effective date is provided for the pension business of TIAA-CREF so that the provision does not apply to that portion of its business until January 1, 1988. | (c) Retain present law. |

## XI. INSURANCE PRODUCTS AND COMPANIES—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **4. Operations loss deduction of insolvent companies** | The Life Insurance Company Tax Act of 1984 repealed the deduction for additions to a policyholders surplus account (PSA), which was originally adopted to provide a cushion of assets to protect the interests of the policyholders. However, a stock life insurance company is required to include in income any amount deemed to be distributed from an existing PSA. | No provision. | A life insurance company is permitted to apply its current loss from operations and its unused loss carryovers to offset taxable income from amounts deemed distributed from its PSA if (1) the company was insolvent on November 15, 1985, (2) the company is liquidated pursuant to a court order in a title 11 or similar case, and (3) as a result of the liquidation, the company's tax liability would be increased due to distributions from the PSA.<br>*Effective date.*—The provision applies to liquidations on or after November 15, 1985. | Same as House bill.<br>*Effective date.*—Same as House bill. |

## XI. INSURANCE PRODUCTS AND COMPANIES—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **C. Property and Casualty Insurance Companies**<br>**1. Reserve deductions** | | | | |
| ***a. Treatment of acquisition expenses*** | (a) A property and casualty insurance company may generally deduct premium acquisition expenses incurred, even though taxation of the associated premium income may be deferred, by means of the unearned premium reserve deduction, to the period to which the premium income relates. | (a) Unearned premium reserves would be subject to the QRA proposal (described in (c) below). | (a) Includes in income of a property and casualty company 20 percent of the unearned premium reserve, phased in at the rate of 4 percent per year over 5 years, and 20 percent of the increase (if any) in the reserve.<br>*Effective date.*—The provision is effective for taxable years beginning after December 31, 1985. | (a) Include annually in income of a property and casualty company 20 percent of the increase (if any) in the unearned premium reserve.<br>Also include in income, ratably over 10 years, 20 percent of the company's unearned premium reserve at the beginning of the year in which the provision is first effective.<br>For this purpose, the unearned premium reserve does not include life insurance reserves.<br>*Effective date.*—The provision would be effective for taxable years beginning after December 31, 1986. |
| ***b. Treatment of tax-exempt income*** | (b) No special treatment applies to the tax-exempt income of a property and casualty insurance company. | (b) No special rule applies to tax-exempt income other than the effect on tax-exempt income of the QRA proposal (see (c) below). | (b) Reduces deductions for loss reserves by 10 percent (15 percent for taxable years beginning after December 31, 1987) of the sum of (i) tax-exempt interest income and (ii) the deductible portion of dividends received. Provides an exception for interest and dividends received or accrued on investments acquired before November 15, 1985.<br>*Effective date.*—The provision is effective for taxable years beginning after December 31, 1985. | (b) Retain present law. |
| ***c. Treatment of loss reserves*** | (c) A property and casualty insurance company may deduct from its gross income the losses incurred during the year. Losses incurred include unpaid losses and losses that have been incurred but not reported ("IBNR" losses), which represents the full amount of actual and estimated insurance losses it expects to pay. The deduction is allowed in the year the losses are incurred or estimated to have been incurred, rather than the year in which they are paid or have accrued under generally applicable principles of tax accounting.<br>This loss reserve deduction rule does not take account of the difference between the time the reserve for losses incurred is established (i.e., the year in which the event covered by insurance occurs) and the time when the items are released from the reserve (i.e., the year in which claims are satisfied or otherwise extinguished). | (c) A property and casualty insurance company's deduction for unearned premiums, and for unpaid losses with respect to a line of business, during a taxable year would be limited to the amount it credits to a qualified reserve account ("QRA").<br>If the total amount credited to a QRA exceeds the statutory reserves for the line of business for which the QRA is established in any year, the excess must be currently included in the company's income. The President's proposal is equivalent to discounting reserve deductions to reflect the time value of money. This is accomplished by increasing each QRA reserve annually by a percentage equal to the after-tax rate of return earned by the company on its investments during that year. No additional reserve deduction would be allowed for this annual increase in the reserve accounts. | (c) Requires that the taxable income of a property and casualty company must bear a relationship to the company's net gain from operations. This rule provides that regular taxable income of a property and casualty insurance company is not less than 20/36 of its adjusted net gain from operations, and its regular taxable loss is not more than 20/36 of its adjusted net loss from operations, as set forth in its annual statement. Tax-exempt income and the deductible portion of certain dividends received attributable to investments made before November 15, 1985, are excluded from adjusted net gain or loss from operations. | (c) Adopt a pretax discounting rule for loss and loss adjustment expense reserves. Reserves for each line of business, including unpaid loss reserves of all insurance companies attributable to accident and health business, would be discounted at a rate initially set at 5 percent and adjusted over 3 years to conform to an appropriate rate. A fixed discount period would be determined for each line of business, but a company would be permitted to elect to discount over a period based on its own experience. |

## XI. INSURANCE PRODUCTS AND COMPANIES—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **1. Loss reserve deductions of property and casualty insurance companies (cont.)**<br>*c. Treatment of loss reserves.—(cont.)* | | A company would be allowed a deduction each year for the full amount paid to satisfy claims, but would be required to include in taxable income an equivalent amount released from the appropriate QRA. Thus, if the reserve was insufficient to cover all claims, the excess claims would produce a net deduction when paid.<br>*Effective date.*—The proposal would be effective for all losses incurred in taxable years beginning after December 31, 1985, that are insured under policies issued after December 31, 1985. | *Effective date.*—The provision is effective for taxable years beginning after December 31, 1987. | *Effective date.*—The provision would be effective with respect to changes in loss reserves for taxable years beginning after December 31, 1986, thereby implementing the rules on a fresh start basis. |
| *d. Study of loss reserves* | | (d) No provision. | (d) Requires the Secretary of the Treasury (in consultation with the Joint Committee on Taxation) to submit to the Congress a study of the treatment of loss reserves. This study is due not later than January 1, 1987.<br>This study is due not later than January 1, 1987. | (d) No provision. |
| **2. Limiting policyholder dividend deduction for mutual companies** | Under present law, property and casualty insurance companies (whether stock or mutual) are generally permitted to deduct dividends and similar distributions paid or declared to policyholders in their capacity as such. Stock companies may not, however, deduct dividends paid to shareholders.<br>This distinction between policyholder and shareholder dividends also exists in the case of life insurance companies, but deductible policyholder dividends paid by mutual life insurance companies are reduced by an amount intended to reflect the portion of the distribution allocable to the companies' earnings and profits (as distinguished from the proportion that is a policyholder rebate). | The President's proposal would require the deduction for policyholder dividends of mutual property and casualty companies to be reduced in a manner similar to the reduction applicable to mutual life insurance companies. The proposal states that additional study is needed to determine the size of the competitive advantage that the current treatment of policyholder dividends provides to mutual property and casualty companies and to set the appropriate deduction limitation.<br>*Effective date.*—The proposal would be effective for taxable years beginning after December 31, 1985. | Requires the Secretary of the Treasury to submit to the Congress a study of the treatment of policyholder dividends by mutual property and casualty insurance companies and whether any changes in such treatment would be appropriate. This study is due not later than January 1, 1987. | Retain present law. |

BEST COPY AVAILABLE

## XI. INSURANCE PRODUCTS AND COMPANIES—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **3. Protection against loss account for mutual companies** | Mutual property and casualty insurance companies are permitted deductions for contributions (which are merely bookkeeping entries) to a protection against loss ("PAL") account. The amount of the deduction is equal to the sum of one percent of the underwriting losses for the year, plus 25 percent of statutory underwriting income, plus certain windstorm and other losses. The account is established for a 5-year period and, in effect, gives a 5-year deferral of a portion of mutual company underwriting income. | The President's proposal would repeal the deduction for contributions to a PAL account. Amounts currently held in the account would be included in income no later than ratably over a 5-year period.<br>*Effective date.*—The proposal would be effective for taxable years beginning after December 31, 1985. | Same as President's proposal.<br>*Effective date.*—Same as President's proposal. | Same as President's proposal.<br>*Effective date.*—The proposal would be effective for taxable years beginning after December 31, 1986. |
| **4. Special exemptions, rates, and deductions of small mutual companies** | Under present law, mutual property and casualty companies are classified into three categories depending upon the amounts of their gross receipts.<br>Mutual companies with certain gross receipts not in excess of $150,000 are tax-exempt.<br>Companies whose gross receipts exceed $150,000 but do not exceed $500,000 are "small mutuals" and may be taxed solely on investment income.<br>Small mutuals which are subject to tax because their gross receipts exceed $150,000 may claim the benefit of a special rule which phases in the regular tax on investment income as gross receipts increase from $150,000 to $250,000. Companies whose gross receipts exceed $500,000 are ordinary mutuals taxed on both investment and underwriting income.<br>Like stock companies, ordinary mutuals generally are subject to the regular corporate income tax rates. Mutuals whose taxable income does not exceed $12,000 are not subject to tax on the first $6,000 of taxable income, and a tax of 30 percent is imposed on the next $6,000 of taxable income. For small mutual companies which are taxable on investment income, no tax is imposed on the first $3,000 of taxable investment income, and a tax of 30 percent is imposed on taxable investment income between $3,000 and $6,000.<br>Mutual companies that receive a gross amount from premiums and certain investment income of less than $1,100,000 are allowed a special deduction against their underwriting income (if it is subject to tax). The maximum amount of the deduction is $6,000, and the deduction phases out as the gross amount increases from $500,000 to $1,100,000. | The special tax exemptions, rate reductions, and deductions of small mutual property and casualty insurance companies would be repealed.<br>*Effective date.*—The proposal would be phased in over a 5-year period starting with the first taxable year beginning after December 31, 1985. | Provides that property and casualty insurance companies (stock or mutual) with net written premiums (or direct written premiums, if greater) of less than $500,000 are exempt from tax, and companies with such premiums equal to or greater than $500,000, but less than $2 million, may elect to be taxed only on investment income.<br>*Effective date.*—The provision is effective for taxable years beginning after December 31, 1985. | Provide that property and casualty companies (stock or mutual) with net written premiums (or direct written premiums, if greater) of less than $350,000 are exempt from tax, and companies with such premiums equal to or greater than $350,000 but less than $1.2 million may elect to be taxed only on investment income.<br>*Effective date.*—The provision would be effective for taxable years beginning after December 31, 1986. |

## XII. INTEREST EXPENSE

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **A. Nonbusiness Interest Limits**<br>**1. General limitation** | The deduction for investment interest of noncorporate taxpayers is limited to the sum of $10,000, plus net investment income, plus certain deductible expenditures in excess of rental income from net lease property.<br>Interest deductions not allowed due to this limitation carry over to future years. | The deduction for all nonbusiness interest of noncorporate taxpayers would be limited to the sum of: interest on debt secured by the taxpayer's principal residence to the extent of its value, plus $5,000, plus net investment income, plus certain deductible expenditures in excess of rental income from net lease property. | Provides that the deduction for nonbusiness interest (in excess of net investment income plus certain deductible expenditures in excess of rental income from net lease property) is limited to the sum of (i) interest on debt secured by the taxpayer's principal residence and a second residence and (ii) $10,000 ($20,000 for joint returns). Residences include housing cooperatives, residential lots and up to 6 weeks of time-sharing of residential property. | The deduction for consumer interest (i.e., nonbusiness interest other than investment interest) is limited to $1,000 ($2,000 for joint returns). The deduction for investment interest (in excess of net investment income plus certain deductible expenditures in excess of rental income from net lease property) is limited to the excess remaining to the taxpayer for the year of the $1,000 (or $2,000) limit applicable to consumer interest. Interest on debt secured by the taxpayer's principal residence and a second residence is not subject to the limitations. Residences include housing cooperatives. |
| **2. Interest subject to limitation** | Investment interest subject to the limitation is interest on debt to purchase or carry investment property. The treatment of interest expense to acquire stock of S corporations or interests in limited partnerships is not entirely clear under present law. | Nonbusiness interest subject to the limitation is broader than present-law investment interest, and would mean all interest not incurred in a trade or business, including the taxpayer's share of interest of S corporations in whose management he does not actively participate, and the taxpayer's share of interest expense of limited partnerships in which he is a limited partner. | Same as the President's proposal, except that investment interest also includes the taxpayer's share of interest expense of certain trusts and other entities in which he is a limited entrepreneur, but does not include interest attributable to certain low income housing. | Same as the President's proposal, except that investment interest also includes the taxpayer's share of interest expense of certain trusts and other entities in which he is a limited entrepreneur. |
| **3. Investment income defined** | Net investment income means investment income net of investment expense. Investment income means interest, dividends, rents, royalties, short-term capital gain from disposition of investment property and depreciation recapture not from conduct of a trade or business. Investment expense means deductible investment expenses (other than interest), except that straight-line (not accelerated) depreciation over useful life, and cost (not percentage) depletion are used in calculating investment expenses. | Investment income is expanded to include the same income items as present law plus the taxpayer's share of all income of S corporations in whose management the taxpayer does not actively participate and his share of all income of limited partnerships in which the taxpayer is a limited partner. Investment expense would be determined the same as under present law, except that the Treasury report RCRS depreciation schedule would be substituted for present-law straight-line depreciation. | Same as President's proposal except that investment income also includes the taxable portion of long-term capital gain and the taxpayer's share of income of certain trusts and other entities in which he is a limited entrepreneur; and investment expense also includes the depreciation and depletion the taxpayer actually utilized rather than RCRS depreciation or cost depletion, so that the net investment income portion of the limitation reflects the taxpayer's actual net investment income subject to tax. | Same as House bill. |
| **4. Net leases** | Property subject to a net lease is treated as an investment, unless the trade or business deductions exceed 15 percent of the rental income. | Retain present law. | Provides that, to the extent the taxpayer performs personal services in lieu of incurring deductible expenses with respect to leased property in certain circumstances, the value of such services may be included with the actual trade or business deductions in determining whether such deductions exceed 15 percent of the rental income. | Same as House bill. |

### XII. INTEREST EXPENSE—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| 5. Rental property | Interest on rental property used for both business and personal purposes (e.g., a vacation home, in some circumstances) is not subject to the interest limitation. Expenses of such rental property are generally allocated to business use in the ratio of the number of days the property is rented at a fair rental to the number of days the property is used in the taxable year. | A portion of interest on business rental property used by the taxpayer for both business and personal purposes (e.g., a vacation home in some circumstances) is treated as business interest not subject to the limitation, in the ratio of the number of days the property is rented at a fair rental to the number of days in the taxable year. | Retains present law regarding allocation of interest on rental property used for both business and personal purposes. Interest expense, in excess of rental income, allocated to rental use of a vacation home used by the taxpayer for personal use more than 14 days during the year (or 10 percent of the time rented, if greater) is treated as nonbusiness interest. | Same as House bill. |
| 6. Effective date | | Subject to two phase-in rules, the limitation would be effective for interest paid or incurred in taxable years beginning on or after January 1, 1986, regardless of when the obligation was incurred. The first phase-in rule is that the $10,000 limit under present law would be reduced to $5,000 for taxable years beginning on or after January 1, 1988. The second phase-in rule is that interest not subject to the limitation under present law, but which would be subject to the expanded limitation, would become subject to the limitation ratably (10 percent per year) over 10 years commencing with taxable years beginning in 1986. Thus, 100 percent of interest subject to the expanded limitation would have become subject to it in taxable years commencing in 1995. | The provision is phased in over 10 years, applicable to taxable years beginning after December 31, 1985. Interest not disallowed under present law, but which is disallowed under the new provision, becomes subject to disallowance ratably (10 percent per year) over 10 years commencing with taxable years beginning in 1986. Thus, 100 percent of interest subject to the expanded limitation becomes subject to it in taxable years commencing in or after 1995. | The provision is phased in over 5 years, applicable to taxable years beginning after December 31, 1986. Interest not disallowed under present law, but which is disallowed under the new provision, becomes subject to disallowance ratably (20 percent per year) over 5 years commencing with taxable years beginning in 1986. Thus, 100 percent of interest subject to the expanded limitation becomes subject to it in taxable years commencing in or after 1991. |
| **B. Deduction for Interest on Loans To Make IRA Contributions** | Under present law, no deduction is allowed for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from tax (sec. 265(2)). This provision does not apply to amounts borrowed to make individual retirement arrangement (IRA) contributions because the interest on an IRA is not wholly exempt from tax. Instead, the income on IRA contributions is not taxed until it is withdrawn. | No provision. | No provision. | Deny a deduction for interest on indebtedness incurred or continued to make a deductible IRA contribution.<br>*Effective date.*—Loans made after December 31, 1986. |

## XIII. MINIMUM TAX

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| A. Individual Minimum Tax<br>1. Structure | An alternative tax, applying to a broader income base and at a lower rate than the regular tax, and payable to the extent in excess of regular tax liabilities. | Same as present law. | Same as present law. | Same as present law. |
| 2. Rate | 20 percent. | Same as present law. | 25 percent. | 20 percent (same as present law). |
| 3. Exemption amount | $40,000 for joint returns, $30,000 for singles, $20,000 for marrieds filing separately. | The sum of the following:<br>(1) $15,000 for joint returns, $12,000 for heads of household, $10,000 for singles, $7,500 for marrieds filing separately;<br>(2) the first $10,000 of preferences; and<br>(3) the taxpayer's personal exemptions. | Same as present law. | Same as present law, except that the exemption amount would be reduced by 25 cents for each $1 that minimum taxable income exceeds $150,000. |
| 4. Tax preferences<br>*a. Dividends excluded from gross income (up to $100 per person, $200 for joint returns)* | (a) Treated as a preference. | (a) Repealed for regular tax purposes. | (a) Same as President's proposal. | (a) Same as President's proposal. |
| *b. Accelerated depreciation on real property* | (b) Excess over straight-line depreciation is a preference. | (b) Same as present law for real property placed in service before 1986. For real property placed in service beginning in 1986, excess over Treasury I depreciation is a preference. | (b) For property placed in service after 1985, treat as a preference the excess of incentive depreciation over nonincentive depreciation. Same as present law for property placed in service before 1986. | (b) For property placed in service after 1986 (other than property grandfathered under the bill's depreciation rules), treat as a preference the excess of (i) ACRS, over (ii) straight-line method using the tax-exempt leasing lives. Same as present law for pre-1987 and grandfathered property. |
| *c. Accelerated depreciation on personal property* | (c) Solely for leased personal property, excess over straight-line depreciation is a preference. | (c) Same as present law for property placed in service before 1986. For leased personal property placed in service beginning in 1986, excess over Treasury I depreciation is a preference. | (c) For property placed in service after 1985, treat as a preference the excess of incentive depreciation over nonincentive depreciation. Same as present law for property placed in service before 1986 (i.e., for leased property only, excess over straight-line is a preference). | (c) For property placed in service after 1986 (other than property grandfathered under the bill's depreciation rules), treat as a preference the excess of (i) ACRS, over (ii) straight-line method using the tax-exempt leasing lives. Same as present law for pre-1987 and grandfathered property (i.e., for leased property only, excess over straight-line is a preference). |

## XIII. MINIMUM TAX—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| *d. Expensing of intangible drilling costs* | (d) Excess over 10-year amortization (or cost depletion), to the extent in excess of net oil and gas income, is a preference. | (d) 8-percent of intangible drilling costs treated as a preference. | (d) Retain present law, except treated as a preference to the extent in excess of 65 percent of net oil and gas income. | (d) Same as present law. |
| *e. 60-month amortization on certified pollution control facilities* | (e) Excess over depreciation otherwise allowable is a preference. | (e) Same as present law for property placed in service before 1986. The provision is repealed for regular tax purposes, effective in 1986. | (e) Same as President's proposal. | (e) Same as President's proposal. |
| *f. Expensing of mining exploration and development costs* | (f) Excess over 10-year amortization is a preference. | (f) Same as present law. | (f) Same as present law. | (f) Same as present law. |
| *g. Expensing of circulation expenditures (for newspapers, magazines, etc.)* | (g) Excess over 3-year amortization is a preference. | (g) Not a preference. | (g) Same as present law. | (g) Same as present law. |
| *h. Expensing of research and experimentation expenditures* | (h) Excess over 10-year amortization is a preference. | (h) Same as present law. | (h) Same as present law. | (h) Same as present law. |
| *i. Percentage depletion* | (i) Excess over adjusted basis of the depletable property is a preference. | (i) Same as present law for property placed in service before 1986. For property placed in service beginning in 1986, excess over cost depletion is a preference. | (i) Same as present law. | (i) Same as present law. |
| *j. Net capital gain deduction* | (j) Treated as a preference. | (j) Same as present law. | (j) Same as President's proposal except that a portion of gain is excluded so that the minimum tax rate, like the regular tax rate on capital gains, is 22 percent.<br>In addition, capital gain on certain transfers of farmland by insolvent farmers is excluded for years after 1984. "Farmers" are defined using a gross receipts test. The provision does not apply unless the taxpayer disposes of 90 percent of his or her farmland during the taxable year. | (j) Same as present law, except that capital gain of certain insolvent farmers would be excluded.<br>The exception for insolvent farmers would (i) apply for years after 198[illegible] (ii) define "farmers" under a material participation test, (iii) not require dispositions of any specific percentage of the taxpayer's farmland, (iv) apply both to farmland and to other real property used for farming purposes (as defined in sec. 2032A(e)(5)), and (v) apply only to the extent of the taxpayer's insolvency. |
| *k. Incentive stock options* | (k) Excess of fair market value of stock over exercise price is a preference. | (k) Same as present law. | (k) Same as present law. | (k) Same as present law. |
| *l. Tax-exempt interest* | (l) Not a preference. | (l) Not a preference. For regular tax purposes, exemption would be repealed for newly issued securities other than governmental obligations. | (l) Treat as a preference interest on any newly issued nonessential function bonds that continue to be exempt. Refundings of pre-1986 bonds not a preference. | (l) Treat all tax-exempt interest as a preference, phased-in ratably over 5 years. |
| *m. Excludable income earned abroad by U.S. citizens* | (m) Not a preference. | (m) Not a preference. | (m) Treat as a preference. | (m) Same as House bill. |

## XIII. MINIMUM TAX—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| *n. Completed contract and other methods of accounting for long-term contracts* | (n) Not a preference. | (n) Not a preference. | (n) Treat as a preference, by requiring use of percentage of completion method, for minimum tax purposes, on post-September 25, 1985 long-term contracts. | (n) Same as House bill for post-March 1, 1986, long term contracts. |
| *o. Installment method of accounting* | (o) Not a preference. | (o) Not a preference. | (o) Not a preference. | (o) Treat as a preference by not permitting dealers to use the installment method for minimum tax purposes on sales after March 1, 1986. The preference would not apply to sales by a manufacturer to a dealer where the term of the dealer's obligation is dependent upon the time that the property is resold or is rented by the dealer, the manufacturer has the right to repurchase the property if the dealer does not rent the property within a specified period, and the amount of the installment obligations exceeds the manufacturer's net worth. |
| *p. Net loss from passive investment activities* | (p) Not a preference. | (p) Not a preference. | (p) To the extent otherwise deductible under minimum tax, treat as a preference the excess net loss with respect to trade or business activities (including the production of rental or royalty income) in which the taxpayer did not materially participate in management or provide substantial personal services. Excess net loss is defined as net loss in excess of cash basis, which includes no more than $50,000 from all of the taxpayer's tax shelter investments. | (p) Same as House bill, except that (1) the preference would apply to the entire net loss without regard to cash basis, (2) the preference would apply to personal service corporations, (3) the preference would be reduced by the amount, if any, of the taxpayer's insolvency, and (4) for 1987, the preference would be reduced by 50 percent of the preference that related to pre-March 1, 1986 investments. |
| *q. Net loss from passive farming activities* | (q) Not a preference. | (q) Not a preference. | (q) Treat as a preference excess passive farm losses. Rule resembles the passive loss rule, except that it applies only to farming, applies separately to each farming activity, and treats as a preference only losses in excess of twice cash basis (without limiting cash basis from tax shelters). | (q) Same as House bill, except that rules (1)-(4) from item *p*, above, would apply. |

## XIII. MINIMUM TAX—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| 5. Itemized deductions | Allowed only for casualty and theft losses, gambling losses to extent of gambling gains, charitable deductions, medical deductions (to the extent in excess of 10 percent of adjusted gross income), interest expenses (restricted to housing interest plus net investment income), and certain estate tax. | Allowed for all itemized deductions retained under the President's proposal, except<br>(i) interest in excess of the sum of housing interest and net investment income; and<br>(ii) for charitable contributions of appreciated property, the amount of untaxed appreciation allowed as a regular tax deduction. | Retain present law, except follow President's proposal with respect to charitable contributions of appreciated property, as modified to provide that preference cannot exceed the amount of the taxpayer's other preferences. | Same as present law, except that all interest attributable to limited business interests (within the meaning of limitation on the deductibility of nonbusiness interest) would be treated as an itemized deduction. The deduction for charitable contributions of appreciated property would not be treated as a preference. |
| 6. Regular tax elections | Taxpayers generally can elect to have minimum tax rules for measuring a particular item apply for regular tax purposes. | No election rules are stated. | Same as present law. | Same as present law. |
| 7. Adjustments in other years when taxpayer pays minimum tax | No provision. | No provision. | Amount of minimum tax liability relating to deferral preferences allowed as a carryforward credit against regular tax liability. | Same as House bill. |
| 8. Incentive credits | Not allowed against minimum tax. Credits that do not benefit the taxpayer due to minimum tax can be used as credit carryovers against regular tax. | Not allowed against minimum tax. No carryover rules are stated. | Same as present law. | Same as present law. |
| 9. Foreign tax credit | Allowed against minimum tax (under limits similar to those applying under regular tax). | Rule is not stated. | Same as present law. | Same as present law, except that foreign tax credits could not offset more than 90% of tentative tax liability. |
| 10. Net operating losses (NOLs) | Allowed against minimum taxable income. For years after 1982, minimum tax NOLs are reduced by the items of tax preference. | Rule is not stated. | Same as present law. | Same as present law. |
| 11. Effective date |  | Taxable years beginning after December 31, 1985. | Same as President's proposal. | Taxable years beginning after December 31, 1986. |

## XIII. MINIMUM TAX—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **B. Corporate Minimum Tax**<br>**1. Structure** | An add-on tax, equalling a percentage of certain preferences minus regular tax paid. | An alternative minimum tax, applying to a base of regular taxable income plus preferences, and payable to the extent in excess of regular tax liability. | Same as President's proposal. | Same as President's proposal |
| **2. Rate** | 15 percent. | 20 percent (same as for individuals). | 25 percent. | 20 percent (same as for individuals). |
| **3. Exemption amount** | The greater of $10,000 or the taxpayer's regular tax liability. | $15,000, plus the first $10,000 of preference income. | $40,000 (same as for individuals filing joint returns under present law). | Same as House bill, except that the exemption amount would be reduced by 25 cents for each $1 that minimum taxable income exceeds $150,000. |
| **4. Tax preferences**<br>***a. Accelerated depreciation on real property*** | (a) Excess over straight-line depreciation is a preference. | (a) Same as present law for property placed in service before 1986; for property placed in service beginning in 1986, excess over Treasury I depreciation is a preference. | (a) For property placed in service after 1985, treat as a preference the excess of incentive depreciation over nonincentive depreciation. Same as present law for property placed in service before 1986. | (a) For property placed in service after 1986 (other than property grandfathered under the bill's depreciation rules), treat as a preference the excess of (i) ACRS, over (ii) straight-line method using the tax-exempt leasing lives. Same as present law for pre-1987 and grandfathered property. |
| ***b. Capital gain preference*** | (b) Benefit of lower rate on capital gains is a preference. | (b) Capital gain fully included in minimum taxable income. | (b) Same as President's proposal. | (b) Same as President's proposal. |
| ***c. 60-month amortization of certified pollution control facilities*** | (c) Excess over depreciation otherwise allowable is a preference. | (c) Same as present law for facilities placed in service before 1986; amortization rule repealed for regular tax purposes beginning in 1986. | (c) Same as President's proposal. | (c) Same as President's proposal. |
| ***d. Bad debt reserve deduction for financial institutions*** | (d) Excess of deduction over amount allowable under the experience method is a preference. | (d) Bad debt reserve deduction is repealed for regular tax purposes. | (d) Same as present law. | (d) Same as present law. |
| ***e. Percentage depletion*** | (e) Excess over adjusted basis of the property is a preference. | (e) Same as present law for property placed in service before 1986; for property placed in service beginning in 1986, excess over cost depletion is a preference. | (e) Same as present law. | (e) Same as present law. |
| ***f. Accelerated depreciation on personal property*** | (f) Not a preference except for personal holding companies (PHCs). For PHCs, applying solely to leased personal property, excess over straight-line depreciation is a preference. | (f) Same as present law for property placed in service before 1986. For leased property placed in service by a PHC beginning in 1986, excess over Treasury I depreciation is a preference. For corporations generally and all personal property, the lesser of (i) excess over Treasury I depreciation, and (ii) 25 percent of the corporation's net interest expense is a preference. | (f) For all corporations and all personal property placed in service after 1985, treat as a preference the excess of incentive depreciation over nonincentive depreciation. Same as present law for property placed in service before 1986 (i.e., solely for leased property placed in service by a PHC, excess over straight-line is a preference). | (f) For property placed in service after 1986 (other than property grandfathered under the bill's depreciation rules), treat as a preference the excess of (i) ACRS over (ii) straight-line method using the tax-exempt leasing lives. Same as present law for pre-1987 and grandfathered property (i.e., solely for leased property placed in service by a PHC, excess over straight-line is a preference). |
| ***g. Expensing of mining exploration and development costs*** | (g) Solely for PHCs, excess over 10-year amortization is a preference. | (g) Treat as a preference for all corporations. | (g) Same as President's proposal. | (g) Same as President's proposal. |

## XIII. MINIMUM TAX—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| ***h. Expensing of intangible drilling costs*** | (h) Solely for PHCs, excess over 10-year amortization (or cost depletion), to the extent in excess of net oil and gas income, is a preference. | (h) For all corporations, 8 percent of intangible drilling costs is treated as a preference. | (h) Treat as a preference for all corporations. Use present-law rule, but with 65 percent net income offset, to measure the preference. | (h) Same as present law, except that preference applies to all corporations. |
| ***i. Expensing of circulation expenditures (by newspapers, magazines, etc.)*** | (i) Solely for PHCs, excess over 3-year amortization is a preference. | (i) Not a preference. | (i) Same as present law. | (i) Same as present law. |
| ***j. Expensing of research and experimentation expenditures*** | (j) Solely for PHCs, excess over 10-year amortization is a preference. | (j) Same as present law. | (j) Not a preference for any corporation. | (j) Same as House bill. |
| ***k. Tax-exempt interest*** | (k) Not a preference. | (k) Not a preference; for regular tax purposes, only governmental obligations remain exempt. | (k) Treat as a preference interest on any newly issued nonessential function bonds that continue to be exempt. Refundings of pre-1986 bonds not a preference. | (k) Treat all tax-exempt interest as a preference, phased-in ratably over 5 years. |
| ***l. Excludable foreign sales corporation (FSC) income*** | (l) Not a preference. | (l) Not a preference. | (l) Treat as a preference. | (l) Not a preference. |
| ***m. Completed contract and other methods of accounting for long-term contracts*** | (m) Not a preference. | (m) Not a preference. | (m) Treat as a preference by requiring use of percentage of completion method, for minimum tax purposes, on post-September 25, 1985 long-term contracts. | (m) Same as House bill for post-March 1, 1986, long-term contracts. |
| ***n. Charitable contributions of appreciated property*** | (n) Not a preference. | (n) Amount of untaxed appreciation claimed as a deduction is a preference. | (n) Same as President's proposal, except that amount of the preference cannot exceed the amount of the taxpayer's other preferences. | (n) Not a preference. |
| ***o. Installment method of accounting*** | (o) Not a preference. | (o) Not a preference. | (o) Not a preference. | (o) Treat as a preference, by not permitting dealers to use the installment method for minimum tax purposes on sales after March 1, 1986. The preference would not apply to sales by a manufacturer to a dealer where the term of the dealer's obligation is dependent upon the time that the property is resold or is rented by the dealer, the manufacturer has the right to repurchase the property if the dealer does not rent the property within a specified period, and the amount of the installment obligations exceeds the manufacturer's net worth. |
| ***p. Capital construction funds for shipping companies*** | (p) Not a preference. | (p) Repealed for regular tax purposes. | (p) Not a preference. | (p) Treat as a preference. |
| ***q. Business untaxed reported profits*** | (q) Differences between book and regular tax treatment of items do not give rise to minimum tax preferences. | (q) Same as present law. | (q) Same as present law. | (q) Treat as a preference 50 percent of the excess of (i) the taxpayer's pre-tax book income (e.g., the income used in reports or statements to shareholders/owners, or in reports to creditors), over (ii) AMTI (determined without regard to this preference and prior to reduction by NOLs). The preference will be computed by consolidating the book income of those corporations which are consolidated for tax purposes. |

## XIII. MINIMUM TAX—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **5. Regular tax elections** | No provision. | No provision. | Permit elections to apply minimum tax rules for regular tax purposes. | Same as House bill. |
| **6. Adjustment in other years when taxpayer pays minimum tax** | No provision. | No provision. | Amount of minimum tax liability can be allowed as a carryforward credit against regular tax liability in other years. | Amount of minimum tax liability relating to deferral preferences would be allowed as a carryforward credit against regular tax liability. |
| **7. Incentive credits** | Not allowed against minimum tax. Credits that do not benefit the taxpayer due to minimum tax can be used as credit carryovers against regular tax. | Not allowed against minimum tax. No carryover rules are stated. | Generally, apply present-law rule under alternative minimum tax on individuals (not allowed against minimum tax but can be carried over). Corporations with NOLs in 2 of the last 3 years before 1986 can use pre-1986 credits to offset 75 percent of minimum tax liability. | Same as present law. |
| **8. Foreign tax credit** | Allowed in calculating add-on tax. | Rule is not stated. | Apply present-law rule under alternative minimum tax on individuals (allowed subject to limits similar to those under regular tax). | Same as House bill, except that foreign tax credits could not offset more than 90% of tentative tax liability. |
| **9. Net operating losses (NOLs)** | Allowed in calculating add-on tax. | Rule is not stated. | Allow against minimum taxable income. For years before 1986, reduce minimum tax NOLs by the items of tax preference under present law. For years after 1985, reduce minimum tax NOLs by all newly enacted items of tax preference. | Same as House bill, adjusted for change in effective date. |
| **10. Estimated tax payments** | Corporations are not required to make estimated tax payments with respect to minimum tax liability. | No provision. | Require that estimated tax payments be made with respect to minimum tax liability. | Same as House bill. |
| **11. Effective date** | | Taxable years beginning after December 31, 1985. | Same as President's proposal. | Taxable years beginning after December 31, 1986. |

## XIV. PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| A. Treatment of Tax-Favored Savings<br>1. Individual retirement arrangements (IRAs) | | | | |
| *a. Spousal IRA* | (a) An individual is permitted an additional deduction for contributions to an IRA for the benefit of the individual's spouse if—<br>(1) the spouse has no compensation for the year,<br>(2) the spouse has not attained age 70½, and<br>(3) the couple files a joint income tax return for the year.<br>If these requirements are met, the annual deduction limit is increased from $2,000 to $2,250. The contribution may be divided as the spouses choose, provided the contribution for neither spouse exceeds $2,000.<br>If both spouses have any compensation, including compensation less than $250, the spousal IRA deduction is not allowed. | (a) For purposes of calculating the spousal IRA deduction limit, all compensation of both spouses could be considered if the couple filed a joint return. Thus, deductible IRA contributions of up to $2,000 per year to each individual's IRA would be permitted for a couple filing a joint return, provided their combined earned income was at least $4,000. | (a) Retains the present-law $2,250 limit on spousal IRAs, but permits the total compensation of a couple filing a joint return to be taken into account in applying the limit. Thus, a spouse with less than $250 of compensation will not be precluded from receiving spousal IRA contributions. See, also, the proposal relating to the coordination of the IRA deduction limit with elective deferrals under tax-favored retirement arrangements, below. | (a) Same as House bill. |
| *b. Additional income tax on early withdrawals* | (b) Amounts withdrawn from an IRA prior to age 59½, death, or disability of the owner are subject to a 10-percent additional income tax. | (b) The additional income tax on IRA withdrawals prior to age 59½, death, or disability would be increased from 10 to 20 percent. The 10-percent tax would continue to apply to distributions made on account of<br>(1) acquisition of the owner's first principal residence,<br>(2) the payment of college expenses of a dependent, or<br>(3) unemployment during a period following the cessation of unemployment benefits. | (b) The additional income tax on IRA withdrawals prior to age 59½, death, or disability is increased from 10 to 15 percent. The tax is waived if the withdrawal is one of a scheduled series of level payments under an annuity for the life of the IRA owner (or the joint lives of the owner and the owner's beneficiary). | (b) Same as House bill. |
| *c. Effective date* | | (c) *Effective date.*—Taxable years beginning after December 31, 1985. | (c) *Effective date.*—Same as President's proposal. | (c) *Effective date.*—Taxable years beginning after December 31, 1986. |

## XIV. PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)—Continued

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **2. Qualified cash or deferred arrangements (sec. 401(k) plans)** | If a cash or deferred arrangement (CODA) meets certain requirements, an employee who has a choice of receiving current pay or having that pay deferred under a profit-sharing or stock bonus plan (or certain pre-ERISA money purchase pension plans) is not taxed as though the compensation had been received. | As modified, the President's proposal would repeal the special treatment of cash or deferred arrangements under present law, effective for years beginning after December 31, 1985. | | |
| ***a. Limit on elective deferrals*** | (a) Elective deferrals under a CODA are subject to the overall limits on annual additions under a defined contribution plan. Thus, under present law, the elective deferrals of any employee (plus employer contributions and certain other amounts) generally cannot exceed the lesser of $30,000 or 25 percent of the employee's nondeferred compensation. | (a) No provision. | (a) Limits the maximum annual elective deferral for an employee under all CODAs' and tax sheltered annuities to $7,000. In addition, reduces an individual's annual cap on deferrals under an eligible State or local deferred compensation plan by the individual's elective deferrals under a CODA or tax-sheltered annuity. | (a) Same as House bill, but also apply the $7,000 annual cap to elective deferrals, which the proposal permits, under a SEP. Elective deferrals under a CODA would reduce, dollar for dollar, the limitation on elective deferrals under other plans in the following order:<br>(1) an eligible State of local deferred compensation plan,<br>(2) a tax-sheltered annuity, and<br>(3) a simplified employee pension (SEP). |
| | | | *Effective date.*—The provision is effective for taxable years beginning after December 31, 1985.<br>In the case of certain collectively bargained plans, the provision is not effective until years beginning on or after the earlier of—<br>(1) the termination of the collective bargaining agreement, or<br>(2) January 1, 1991. | *Effective date.*—The provision is effective for taxable years beginning after December 31, 1986.<br>In the case of certain collectively bargained plans, the provision is not effective until years beginning on or after the earlier of—<br>(1) the termination of the collective bargaining agreement, or<br>(2) January 1, 1991. |
| ***b. Coordination with IRA contributions*** | (b) Under persent law, the limit on an employee's elective deferrals under a CODA is not coordinated with the limit on an employee's deductible IRA contributions. | (b) No provision. | (b) Similar to President's proposal of May 1985 (before modification), reduces an employee's IRA deduction limit, dollar for dollar, by the employee's elective deferrals under a CODA and a tax-sheltered annuity. Also provides for the reduction of the first $2,000 of the spousal IRA deduction limit. | (b) An individual's IRA deduction limit would be reduced, dollar for dollar, by the amount in excess of $5,000 of the individual's elective deferrals under a CODA and other tax-favored retirement arrangements. The first $2,000 of an individual's spousal IRA deduction limit would be similarly reduced. |
| | | | *Effective date.*—The provision is effective for taxable years beginning after December 31, 1985.<br>In the case of certain collectively bargained plans, the provision is not effective until years beginning on or after the earlier of—<br>(1) the termination of the collective bargaining agreement, or<br>(2) January 1, 1991. | *Effective date.*—The provision is effective for taxable years beginning after December 31, 1986.<br>In the case of certain collectively bargained plans, the provision is not effective until years beginning on or after the earlier of—<br>(1) the termination of the collective bargaining agreement, or<br>(2) January 1, 1991. |

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| *c. Nondiscrimination requirements* | (c) A special nondiscrimination test applies a limit on elective deferrals under a CODA by the group of highly paid employees that is determined by reference to the rate of deferrals by other employees. | (c) No provision. | (c) Similar to President's proposal of May 1985 (before modification), modifies the special nondiscrimination tests applicable to qualified CODAs by redefining the group of highly compensated employees and by revising the special percentage tests. | (c) Same as House bill with respect to the special nondiscrimination test. |
| | *Highly compensated employees.*—An employee is considered highly paid, for this purpose, if the employee is more highly paid than ⅔ of all employees eligible to participate in the plan. | | *Highly compensated employees.*—Treats an employee as highly compensated if, at any time during the 2 preceding years, the employee was—<br>(1) a 5-percent owner (determined with attribution rules);<br>(2) earned more than $50,000 annually; or<br>(3) was in the top 10 percent of all employees by pay excluding<br>(i) employees who earned less than $20,000; and<br>(ii) employees who earned less than $35,000 and were not among the top 5 percent by pay. | *Highly compensated employees.*—Same as present law. |
| | | | "Highly compensated employees" also includes employees who are 5-percent owners during the current year, and employees in categories (2) or (3) during the current year and who are also in the top 100 employees by pay during the current year. | |
| | | | Elective deferrals of family members of<br>(a) 5-percent owners, and<br>(b) the top 10 highly compensated employees by pay are aggregated with the elective deferrals of such highly compensated employees for purposes of applying the special nondiscrimination tests.<br>A family member is defined as a spouse, parent, lineal ascendant or descendant, and a spouse of a lineal ascendant or descendant. | The elective deferrals of family members of—<br>(a) 5-percent owners, and<br>(b) the top 10 highly compensated employees by pay<br>would be aggregated with the elective deferrals of such highly compensated employees for purposes of applying the special nondiscrimination tests.<br>A family member would be defined as a spouse, parent, lineal ascendant or descendant, and spouses of a lineal ascendant or descendant. |

BEST COPY AVAILABLE

## XIV. PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)—Continued

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| ***c. Nondiscrimination requirements (cont.)*** | *Nondiscrimination test.*—A CODA meets the special nondiscrimination test for a plan year if—<br>(1) the average deferral percentage for the highly paid employees does not exceed the average deferral percentage for the other eligible employees by more than 150 percent, or<br>(2) The average deferral percentage for the highly paid employees does not exceed the average deferral percentage of the other eligible employees by more than<br>(a) 250 percent and<br>(b) the average of the other eligible employees plus three percentage points. | | *Nondiscrimination test.*—Alters the special nondiscrimination test to provide that the test is met for a year if the average deferral percentage for the highly compensated employees does not exceed the greater of<br>(1) 125 percent of the average deferral percentage for all other eligible employees, or<br>(2) the lesser of<br>(i) 200 percent of the average deferral percentage for all other eligible employees; or<br>(ii) such average, plus 2 percentage points.<br>If the special nondiscrimination test is not satisfied for any year, the bill provides that the excess elective deferrals of highly compensated employees are subject to a 10 percent excise tax unless distributed within 2½ months after the end of the year of deferral. Violation of the special nondiscrimination test will not cause the disqualification of the plan if excess elective deferrals are distributed by the end of the year following the year of deferral. | *Nondiscrimination test.*—Same as House bill. |
| | | | *Effective date.*—The provision applies for taxable years beginning after December 31, 1985.<br>In the case of certain collectively bargained plans, the provisions are not effective until years beginning on or after the earlier of—<br>(1) the termination of the collective bargaining agreement, or<br>(2) January 1, 1991.<br>In the case of a CODA maintained by a public employer that is grandfathered under the rules of the next subsection, the new nondiscrimination rules do not apply for years beginning before November 22, 1987. | *Effective date.*—The provision would be effective for taxable years beginning after December 31, 1986.<br>In the case of certain collectively bargained plans, the provisions are not effective until years beginning on or after the earlier of—<br>(1) the termination of the collective bargaining agreement, or<br>(2) January 1, 1991.<br>In the case of a CODA that is maintained by a public employer and that was in existence as of March 1, 1986, the provision is effective for plans years beginning after December 31, 1988. |

XIV. PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)—Continued

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| *d. Withdrawal and other restrictions* | (d) A participant in a qualified CODA is not permitted to withdraw elective deferrals (or earnings thereon) before age 59½, death, disability, separation from service, retirement, or the occurrence of a hardship.<br>It is unclear under present law whether tax-exempt and public employers may establish a CODA. In GCM 38283, the IRS determined that a tax-exempt organization could maintain a profit-sharing plan.<br>The IRS subsequently issued determination letters on the qualified status of CODAs maintained by tax-exempt and State and local governments, but ceased issuing determination letters during 1985. | (d) No provision. | (d) Imposes the following additional restrictions on CODAs:<br>(1) Limit hardship withdrawals to an employee's elective deferrals;<br>(2) withdrawals on account of plan termination would be permitted;<br>(3) An employer could not condition, either directly or indirectly (other than through matching contributions), contributions and benefits upon an employee's elective deferrals;<br>(4) Employees could not be required to complete more than one year of service to be eligible to defer; and<br>(5) CODAs would not be available to employees of tax exempt and public employers.<br>*Effective dates.*—Generally effective for plan years beginning after December 31, 1985.<br>In the case of certain collectively bargained plans, the provisions are not effective until years beginning on or after the earlier of<br>(1) the termination of the collective bargaining agreement, or<br>(2) January 1, 1991.<br>*State and local governments.*—The provision under which State and local governments may not maintain a CODA does not apply to plans adopted before November 6, 1985, if the State and local government submitted a determination letter request to the IRS by that date. With respect to those State and local government plans grandfathered under the preceding rule, the new withdrawal restrictions do not apply for years beginning before November 22, 1987.<br>*Qualified offset arrangements.*—A transition rule is provided for the provision that an employer cannot offset benefits under defined benefit plan by an employee's elective deferrals. The transition rule delays the effective date of the provision until plan years beginning on or after January 1, 1991, in the case of a "qualified offset arrangement." | (d)—Imposes the following additional restrictions on CODAs:<br>(1) Same as House bill.<br>(2) Same as House bill.<br>(3) Same as House bill.<br>(4) Same as House bill.<br>(5) CODAs would be available to employees of tax-exempt and public employers.<br>*Effective dates.*—Generally effective for plan years beginning after December 31, 1986.<br>In the case of certain collectively bargained plans, the provisions would not be effective until years beginning on or after the earlier of<br>(1) the termination of the collective bargaining agreement, or<br>(2) January 1, 1991.<br>*State and local governments.*—The provision clarifying that tax-exempt and public employers may maintain CODAs is effective immediately. The withdrawal and other miscellaneous restrictions are not effective with respect to CODAs that are maintained by public employers and that were in existence as of March 1, 1986, until plan years beginning after December 31, 1988.<br>*Qualified offset arrangements.*—No provision. |

BEST COPY AVAILABLE

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **3. Employer matching contributions and employee contributions** | | | | |
| ***a. Employer matching and employee contributions*** | (a) If an employer contribution under a qualified plan is conditioned on an employee's contribution, the employer matching contribution must be a uniform percentage of compensation (adjusted, in an integrated plan, for certain social security benefits). | (a) Under the proposal, two special nondiscrimination tests would be applied to employer matching contributions under any qualified plan. An aggregation rule would apply if employer matching contributions are tied to elective deferrals under a CODA. | (a) Same as President's proposal, but with the following modifications and also applied to employee contributions. | (a) Same as President's proposal, with the following modifications. A single special nondiscrimination test would be applied to all types of employer matching contributions and employee contributions. The proposal does not create separate categories of employer matching contributions. |
| | An employer may elect to treat certain employer matching contributions to a CODA under the special nondiscrimination tests which permit higher contributions (as a percentage of compensation) for the top ⅓ of employees by compensation, but which do not permit social security benefits to be taken into account. Employer matching contributions may be tested under the special nondiscrimination test if the contributions are fully vested and subject to the withdrawal restrictions applicable to CODAs. | *Qualifying employer matching contributions.*—Qualifying employer matching contributions for any highly compensated employee (expressed as a percentage of pay) would be limited to the greater of—<br>(1) 125 percent of the average matching contributions (expressed as a percentage of pay) for nonhighly compensated employees, or<br>(2) the lesser of<br>(i) 200 percent of the average for nonhighly compensated employees or<br>(ii) the average plus 2 percentage points. | *Qualifying employer matching and employee contributions.*—The average qualifying employer matching contributions and employee contributions (expressed as a percentage of pay) for highly compensated employees is limited to the greater of<br>(1) 125 percent of the average employer matching contributions and employee contributions (expressed as a percentage of pay) for nonhighly compensated employees, or<br>(2) the lesser of<br>(i) 200 percent of the average for nonhighly compensated employees, or<br>(ii) such average, plus 2 percentage points. | *Employer matching and employee contributions.*—Under this test, the average employer matching contributions and employee contributions (expressed as a percentage of pay) for highly compensated employees would be limited to the greater of<br>(1) 125 percent of the average employer matching contributions and employee contributions (expressed as a percentage of pay) for the nonhighly compensated employees or<br>(2) the lesser of<br>(i) 200 percent of the average for the nonhighly compensated employees, or<br>(ii) such average plus 2 percentage points. |
| | | The definition of highly compensated employees is the same as the definition for CODAs.<br>Qualifying employer matching contributions are required to be—<br>(1) nonforfeitable when made,<br>(2) ineligible for withdrawal prior to the employee's death, disability, separation from service, or plan termination, and<br>(3) no greater than 100 perent of the employee's mandatory contributions. | The definition of highly compensated employees is the same as the definition for CODAs.<br>Qualifying employer matching contributions are required to be—<br>(1) nonforfeitable when made,<br>(2) ineligible for withdrawal prior to the employee's death, disability, separation from service, or plan termination, and<br>(3) no greater than 100 percent of the employees' mandatory contributions. | The definition of highly compensated employees is the same as the definition for CODAs. |

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| *a. Employer matching and employee contributions (cont.)* | | *Other employer matching contributions.*—Under the proposal, employer matching contributions that are not qualifying employer matching contributions for any highly compensated employee would be limited to the greater of—<br>(1) 110 percent of the average nonqualifying contributions for the nonhighly compensated employees, or<br>(2) the lesser of<br>(i) 150 percent of the average nonqualifying contributions for nonhighly compensated employees or<br>(ii) the average percentage plus one percentage point.<br>If the nonqualifying employer matching contributions are tied to elective contributions under a qualified cash or deferred arrangement, then this test would be applied by aggregating nonqualifying employer matching contributions and elective deferrals. | *Other employer matching contributions.*—The average of nonqualifying employer matching contributions (expressed as a percentage of pay) for highly compensated employees is limited to the greater of<br>(1) 110 percent of the average nonqualifying employer matching contributions (expressed as a percentage of pay) for the nonhighly compensated employees; or<br>(2) the lesser of<br>(i) 150 percent of the average for nonhighly compensated employees; or<br>(ii) such average, plus 1 percentage point. | *Other employer matching contributions.*—No provision. |
| *b. Excess contributions* | (b) If employer matching contributions discriminate in favor of employees who are officers, shareholders or highly compensated, the plan is disqualified. | (b) Under the President's proposal—<br>(1) the employer would be denied a deduction for any contributions on behalf of highly compensated employees in excess of the amount permitted under the matching contribution rules,<br>(2) those excess contributions would be subject to a nondeductible 10-percent excise tax, and<br>(3) unless the excess contributions (plus earnings thereon) were distributed by the end of the plan year following the year for which the contributions were made, the plan would be retroactively disqualified. | (b) If the special nondiscrimination tests for employer matching and employee contributions are not satisfied, the bill provides that—<br>(1) the excess contributions are subject to a 10-percent excise tax unless distributed within 2½ months after the end of the year in which the contributions were made, and<br>(2) unless the excess contributions are distributed no later than the end of the plan year following the year in which the contributions were made, the plan will be retroactively disqualified. | (b) Same as House bill. |
| | | *Effective date.*—The proposals would apply generally to plan years beginning after December 31, 1985.<br>For collectively bargained plans, the proposals would apply to plan years beginning after the termination of the collective bargining agreement. | *Effective dates.*—Generally effective for plan years beginning after December 31, 1985.<br>In the case of certain collectively bargained plans, the provisions are not effective until years beginning on or after the earlier of<br>(1) the termination of the collective bargaining agreement, or<br>(2) January 1, 1991.<br>In addition, with respect to any plan that is maintained by a State or local government and that was in existence on November 6, 1985, the provisions do not apply until years beginning after November 21, 1987. | *Effective dates.*—Generally effective for plans years beginning after December 31, 1986.<br>In the case of certain collectively bargained plans, the provisions would not be effective until years beginning on or after the earlier of—<br>(1) the termination of the collectively bargaining agreement, or<br>(2) January 1, 1991.<br>In the case of a plan that is maintained by a State or local government and that was in existence as of March 1, 1986, the provisions would not apply until years beginning after December 31, 1988. |

## XIV. PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)—Continued

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **4. Unfunded deferred compensation arrangements of State and local governments and tax-exempt employers** | | | | |
| ***a. Eligible plan*** | (a) Under an eligible deferred compensation plan maintained by a State or local government or rural electric cooperative, an employee may elect annual deferrals equal to the lesser of $7,500 or 33⅓ percent of compensation (net of the deferral). A participant in an eligible plan who elects to defer the receipt of current compensation will be taxed on the deferred amounts (and income attributable thereto) when such amounts are paid or otherwise made available.<br>If an unfunded State or local plan (other than an eligible judicial plan) does not qualify as an eligible plan, the deferral is included in the employee's gross income when there is no longer a substantial risk of forfeiture of such amount. | (a) The proposal would provide that the rules relating to eligible deferred compensation plans would apply to unfunded deferred compensation plans for employees of tax-exempt employers. | (a) Same as President's proposal. | (a) Retain present law. |
| ***b. Required distributions*** | (b) Distributions under an eligible plan are required to commence no later than 60 days after the later of (1) the year in which the employee attains normal retirement age, or (2) the year in which the employee separates from service. The total benefits scheduled to be paid to the participant must be more than 50 percent of the maximum amount that could have been paid to the participant if no provision were made for payments to the beneficiary. | (b)(1) *Required distributions.*—Under the proposal, distributions would be required—<br>(i) to satisfy a payout schedule under which benefits projected to be paid over the lifetime of the participant are at least 66⅔ percent of the total benefits payable with respect to the participant,<br>(ii) in the case of benefits payable over a period of more than one year, to be paid on a substantially nonincreasing basis, and<br>(iii) after the death of the employee, to provide for the commencement of benefits to the employee's beneficiary within one year after the employee's death. | (b)(1) *Required distributions.*—Same as President's proposal, except that the new distribution requirements would not apply to certain qualified State judicial plans. | (b)(1) *Required distributions.*—Same as House bill. |
| | | (2) *Constructive receipt.*—Under the proposal, benefits would not be treated as made available merely because an employee is allowed to elect to receive a lump sum payable within 60 days of the election. This rule applies only if the employee's total deferred benefit does not exceed $3,500 and the employee is no longer entitled to elect deferrals under the plan. | (2) *Constructive receipt.*—Same as President's proposal. | (2) *Constructive receipt.*—Same as President's proposal. |
| | | (3) *Rollovers.*—Certain tax-free rollovers between eligible plans would be permitted. | (3) *Rollovers.*—Same as President's proposal. | (3) *Rollovers.*—Same as President's proposal. |

## XIV. PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)—Continued

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| | | (4) *Coordination with other contributions.*—As under present law, the amount that a participant may defer under an eligible deferred compensation plan is reduced by contributions under a tax-sheltered annuity. | (4) *Coordination with other contributions.*—The amount that a participant may defer under an eligible deferred compensation plan is reduced, dollar for dollar, by the participant's elective deferrals under a CODA (except a CODA maintained by a rural electric cooperative) and, as under present law, by contributions under a tax-sheltered annuity. | (4) *Coordination with other contributions.*—The amount that a participant may defer under an eligible deferred compensation plan is reduced, dollar for dollar, by the participant's elective deferrals under a CODA, by contributions under a tax-sheltered annuity (as under present law), and by elective deferrals under a SEP. |
| *c. Effective date* | | (c) *Effective date.*—The provisions would apply to taxable years beginning after December 31, 1985. | (c) *Effective date.*—Same as President's proposal. | (c) *Effective date.*—Effective for years beginning after December 31, 1986. |
| **5. Deferred annuity contracts** | (a) *Investment earnings.*—Interest credited to the cash surrender value of a deferred annuity is not taxed currently, but is taxed when paid to the policyholder. | (a) *Investment earnings.*—The owner of a deferred annuity contract would include in income any increase in the excess of the contract's cash value over the owner's investment in the contract during the taxable year. | (a) *Investment earnings.*—Modifies President's proposal to tax currently the increase in value of a deferred annuity if the owner is a nonnatural person (such as a corporation). | (a) *Investment earnings.*—Same as House bill. |
| | (b) *Early withdrawal tax.*—If a policyholder receives any amount under an annuity contract before reaching age 59½, an additional income tax is imposed equal to five percent of the amount included in income. This tax does not apply if the distribution is one of a series of periodic payments lasting at least 60 months or is made for certain other purposes. | (b) *Early withdrawal tax.*—Same as present law. | (b) *Early withdrawal tax.*—The additional income tax on amounts withdrawn from deferred annuity contracts before age 59½ is conformed to the 15-percent tax on early withdrawals from IRAs. The penalty is waived if the withdrawal is one of a scheduled series of level payments over the life of the annuitant or over the joint lives of the annuitant and the annuitant's beneficiary. | (b) *Early withdrawal tax.*—Same as House bill. |
| | | *Effective date.*—The proposal would become effective for investment income credited after December 31, 1985, to policies issued on or after the date of committee action. | *Effective date.*—The provision is effective for amounts invested in deferred annuity contracts after September 25, 1985. | *Effective date.*—Effective for amounts invested in deferred annuity contracts after February 28, 1986. |

XIV. PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)—Continued

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **6. Elective contributions under tax-sheltered annuities** | Under present law, public schools and certain tax-exempt organizations (including churches and certain organizations associated with churches) may make payments on behalf of an employee to purchase a tax-sheltered annuity contract (sec. 403(b)). Payments to a custodial account investing in stock of a regulated investment company (e.g., a mutual fund) are also pemitted.<br>The amount paid by the employer is excluded from the employee's income for the taxable year to the extent the payment does not exceed the employee's exclusion allowance for the taxable year. The exclusion allowance is generally equal to 20 percent of the employee's includible compensation from the employer multiplied by the number of the employee's years of service with the employer, reduced by amounts already paid by the employer to purchase the annuity (sec. 403(b)(2)).<br>Employer payments to purchase a tax-sheltered annuity contract for an employee are also subject to the overall limits on contributions and benefits under qualified plans (sec. 415). Because tax-sheltered annuities generally are defined contribution plans, the limit on the annual additions on behalf of an employee generally is the lesser of 25 percent of compensation or $30,000. Certain catch-up elections allow an employer to contribute in excess of the usual percentge limits in certain years. | *Limit on elective deferrals.*—No provision. | *Limit on elective deferrals.*—Limits to $7,000 the amount that an employee can elect to defer for any taxable year under all tax-sheltered annuities in which the employee participates. | *Limit on elective deferrals.*—Same as House bill. |
| | | *Coordination with other elective deferrals.*—No provision. | *Coordination with other elective deferrals.*—An individual's elective deferrals under a CODA reduce, dollar for dollar, the $7,000 cap on the individual's elective deferrals under a tax-sheltered annuity. As under present law, an individual's contributions under a tax-sheltered annuity would reduce, dollar for dollar, the limitation on the amount that an individual could elect to defer under an eligible unfunded deferred compensation plan (sec. 457). | *Coordination with other elective deferrals.*—Same as House bill, except that an individual's elective deferrals under a SEP would reduce, dollar for dollar, the limit on an employee's elective deferrals under a tax-sheltered annuity. |
| | | *Coordination with IRA deduction limit.*—No provision. | *Coordination with IRA deduction limit.*—An individual's IRA deduction limit is reduced, dollar for dollar, by the employee's elective deferrals under a tax-sheltered annuity. | *Coordination with IRA deduction limit.*—An individual's IRA deduction limit would be reduced, dollar for dollar, by the amounts in excess of $5,000 of the individual's elective deferrals under all tax-sheltered annuities and other tax-favored retirement arrangements. |
| | | *Special catch-up election.*—No provision. | *Special catch-up election.*—Special catch-up election provides a limited exception to the $7,000 annual limit (but not the otherwise applicable exclusion allowance (sec. 403(b)) or the overall limit on contributions and benefits (sec. 415) in the case of employees of an educational organization, a hospital, a home health service agency, or a church, convention, or association of churches. The catch up is limited to $3,000 per year (up to $15,000) and is available only to employees with at least 15 years of service whose contributions have not, on average, exceeded $5,000 per year. | *Special catch-up election.*—Same as House bill except that employees of certain health and welfare service agencies would also be eligible for the special catch-up election. |
| | | | *Effective dates.*—The provisions generally are effective for years beginning after December 31, 1985.<br>In the case of certain collective bargaining agreements, the provisions do not apply to contributions made under such an agreement in taxable years beginning before the earlier of—<br>(1) the date on which the last of the collective bargaining agreements terminates, or<br>(2) January 1, 1991. | *Effective dates.*—The provisions generally are effective for plan years beginning after December 31, 1986.<br>In the case of certain collectively bargained plans, the provisions would not apply to contributions made under such an agreement in taxable years beginning before the earlier of—<br>(1) the termination of the collective bargaining agreement, or<br>(2) January 1, 1991. |

BEST COPY AVAILABLE

## XIV. PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)—Continued

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| 7. **Special rules for simplified employee pensions** | Under present law, if an IRA qualifies as a simplified employee pension (SEP), the annual IRA deduction limit is increased to the lesser of—<br>(1) $30,000 or<br>(2) 15 percent of compensation. The increased deduction limit applies only to employer contributions.<br>Employer contributions under a SEP are considered discriminatory unless contributions thereto bear a uniform relationship to compensation. | | | |
| *a. Limit on elective deferrals* | (a) *Limit on elective deferrals.*—Present law does not permit elective deferrals under a SEP. | (a) *Limit on elective deferrals.*—No provisions. | (a) *Limit on elective deferrals.*—No provisions. | (a) *Limit on elective deferrals.*—Permit employees participating in a SEP to make elective deferrals of up to $7,000 under the SEP, provided that:<br>(a) the employer maintaining the SEP has 25 or fewer employees, and<br>(b) at least 50 percent of the employees of the employer elect to have amounts contributed to the SEP.<br>Limit the average amount deferred as a percentage of compensation (deferral percentage) for each highly compensated employee to no more than 125 percent of the average deferral percentage of all other participating employees. (Employer contributions would be subject to the nondiscrimination rules of present law). The definition of highly compensated employees is the same as the definition for CODAs. |
| *b. Coordination with IRA deduction limit* | (b) *Coordination with IRA deduction limit.*—Present law does not coordinate the limit on SEP contributions with the IRA deduction limit. | (b) *Coordination with IRA deduction* | (b) *Coordination with IRA deduction* | (b) *Coordination with IRA deduction limit.*—The amount of an employee's IRA deduction limit (other than the limit for SEP contributions), would be reduced, dollar for dollar, by the employee's elective deferrals in excess of $5,000 under the SEP. |
| *c. Coordination with other elective deferrals* | (c) *Coordination with other elective deferrals*—No provision. | (c) *Coordination with other elective deferrals.*—No provision. | (c) *Coordination with other elective deferrals.*—No provision. | (c) *Coordination with other elective deferrals.*—The limit on an employee's elective deferrals under a SEP would be reduced, dollar for dollar, by an employee's elective deferrals under a CODA or tax-sheltered annuity. An employee's elective deferrals under a SEP would reduce, dollar for dollar, the limit on the employee's deferrals under an eligible unfunded deferred compensation plan (sec. 457).<br>*Effective date.*—Effective for years beginning after December 31, 1986. |

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **B. Minimum Standards for Qualified Plans**<br>**1. Nondiscrimination rules**<br>***a. Coverage requirements for qualified plans*** | (a) The coverage rules for qualified plans require that a plan cover employees in general rather than merely employees who are officers, shareholders, or highly compensated. A plan generally satisfies the coverage rules if it meets either<br>(1) a percentage test, or<br>(2) a fair cross-section test. | (a) Revises the coverage test for qualified plans, as described below. | (a) Directs the Secretary of the Treasury to study the effect of the present-law coverage tests, and to report to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate, as well as the Joint Committee on Taxation, by July 1, 1986. The report is to include specific recommendations of any changes that the Secretary finds to be appropriate or necessary, including recommendations for implementing those changes. | (a) As under present law, a plan would generally satisfy the coverage rules if it meets either<br>(1) a percentage test, or<br>(2) a fair cross-section test. |
|  | *Percentage test.*—A plan meets the percentage test if<br>(1) it benefits at least 70 percent of all employees, or<br>(2) it benefits at least 80 percent of the employees eligible to benefit under the plan and at least 70 percent of all employees are eligible (i.e., the plan benefits at least 56 percent of all employees). | *Percentage test.*—The proposal provides that the coverage test would be met only if the percentage of highly compensated employees eligible to receive benefits does not exceed 125 percent of the percentage of all other employees receiving benefits. Under certain very limited circumstances in the case of a compelling business reason (such as a merger), the IRS could waive the 125 percent test in favor of a more liberal test for a period of time. |  | *Percentage test.*—A plan would meet the percentage test if the plan benefits at least 80 percent of the employees. |
|  | *Fair cross-section test.*—A plan meets the fair cross-section test if the Secretary of the Treasury determines that it covers a classification of employees that is found not to discriminate in favor of employees who are officers, shareholders, or highly compensated.<br>IRS regulations provide that, in determining whether the fair cross-section test is satisfied, all of the surrounding facts and circumstances must be taken into account, allowing for a reasonable difference between the percentage of officers, shareholders, or highly compensated employees who are benefited by the plan and the percentage of other employees benefited by the plan. The regulations do not preclude consideration of the existence of separate lines of business as a fact or circumstance justifying a reasonable disparity. | *Fair cross-section test.*—Repeal present law. |  | *Fair cross-section test.*—A plan would meet the fair cross-section test if the Secretary of the Treasury determines that it covers a reasonable classification of employees that is found not to discriminate in favor of highly compensated employees. The proposal would direct the Secretary of the Treasury to revoke Rev. Rul. 83-58 and to apply the regulations under section 410(b). In addition, the proposal would clarify that reasonable disparities between the coverage of highly compensated employees and the coverage of nonhighly compensated employees would be permitted if justified by the attendant facts and circumstances, including the existence of separate lines of business. |

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| ***a. Coverage requirements for qualified plans (cont.)*** | Under Revenue Ruling 83-58, the IRS ruled that a plan satisfied the fair cross-section test under the following facts and circumstances:<br>(1) the plan covered only salaried employees;<br>(2) the plan covered 40 out of 150 employees (27 percent of all employees);<br>(3) 55 percent of the employees participating in the plan were officers or shareholders of the employer; and,<br>(4) the plan covered 100 percent of those employees with compensation greater than $40,000 (100 percent of whom were officers and shareholders) and only 25 percent of employees whose compensation was less than $40,000 (50 percent of whom were officers or shareholders). | | | If an employer maintained separate lines of business or operating units, those separate lines of business or operating units would be recognized under a safe harbor rule if the following conditions are satisfied:<br>(1) each line of business or operating unit is capable of being a separate self-sustaining unit,<br>(2) each line of business or operating unit has at least 50 employees, and<br>(3) the percentage of highly compensated employees within any line of business or operating unit cannot be less than 50 percent or more than 200 percent of the percentage of highly compensated employees of the employer. |
| | *Highly compensated employees.*—Present law does not explicitly define the group of employees who are officers, shareholders, or highly compensated. | *Highly compensated employees.*—The proposal would provide a uniform definition of highly compensated employees. An employee would be treated as highly compensated for a plan year if, at any time during the three-year period ending on the last day of the plan year, the employee—<br>(1) owns an interest of at least one percent of the employer (determined with attribution rules).<br>(2) earns at least $50,000 in annual compensation from the employer;<br>(3) earns at least $20,000 in compensation and is among<br>(a) the top 10 percent of employees by compensation, or<br>(b) the top three employees by compensation; or<br>(4) is a family member of another highly compensated employee for such year.<br>Certain mechanical adjustments would be made to the top ten-percent and three highest-paid employees tests to take into account an employer's salary structure. Similarly, adjustments would be provided to the three-year lookback rule to reflect significant fluctuations in an employer's workforce. | | *Highly compensated employees.*—An employee would be treated as highly compensated if, at any time during the preceding year, the employee—<br>(1) was a 5-percent owner (determined with attribution rules)<br>(2) earned<br>(a) more than $100,000 (indexed by reference to the percentage increase in the social security wage base) or<br>(b) more than $50,000 (indexed by reference to the percentage increase in the social security wage base) and was among the top 20 percent of employees by pay;<br>(3) was an officer (as defined in sec. 416(i))<br>Family members of 5-percent owners and of the 10 (by comparison) highly compensated employees are aggregated with the 5 percent owner or highly compensated employee and, therefore, are treated as a single-highly compensated employee. A family member would be defined as a spouse, parent, lineal ascendant or descendant, and a spouse of a lineal ascendant or descendant. |

BLANK PAGE

BLANK PAGE

BLANK PAGE

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| *a. Coverage requirements for qualified plans (cont.)* | | | | "Highly compensated employees" would also include employees who are 5-percent owners during the current year, and employees who fall in categories (2) or (3) during the current year and who are also in the top 100 employees by pay during the current year.<br>The definition of highly compensated for purposes of the coverage rules would also apply for purposes of testing the benefits or contributions under a plan for discrimination (sec. 401(a)(4)). |
| | *Excludable employees.*—In applying the percentage test, certain employees who have not<br>(1) completed minimum periods of service (generally one year), and<br>(2) attained age 21 may be disregarded.<br>Employees with less than three years of service may be excluded if the plan provides for full and immediate vesting. In addition, in applying both the percentage and the fair cross-section test, employees not covered by the plan who are included in a unit of employees covered by a collective bargaining agreement are disregarded if there is evidence that retirement benefits were the subject of good faith bargaining. Certain nonresident aliens and certain airline pilots also are disregarded. | *Excludable employees.*—The proposal would narrow the class of employees who could be excluded from consideration in applying the percentage test by repealing the exceptions for employees with less than three years of service and for certain airline pilots.<br>*Effective date.*—The President's proposal would be effective for plan years beginning after December 31, 1986. For collectively bargained plans, the proposal would not apply to plan years beginning before the termination of the current collective bargaining agreement. | | *Excludable employees.*—Same as present law.<br>*Effective dates.*—Generally effective for plan years beginning after December 31, 1988. In the case of certain collectively bargained plans, the provision would not be effective until years beginning on or after the earlier of<br>(1) the termination of the collective bargaining agreement, or<br>(2) January 1, 1991. |
| *b. Minimum participation requirement* | (b) *Minimum participation requirement.*—No provision. | (b) *Minimum participation requirement.*—No provision. | (b) *Minimum participation requirement.*—No provision. | **(b) *Minimum participation requirement.*—A plan would be required to cover the lesser of 50 employees or 80 percent of all of an employer's nonexcludable employees, effective for plan years beginning after 1988.** |
| *c. Nondiscrimination rules applicable to tax-sheltered annuities* | (c) Under present law, a qualified plan is required to meet requirements as to coverage and as to contributions and benefits provided under the plan, which ensure that the plan does not discriminate in favor of employees who are officers, shareholders, or highly compensated. A tax-sheltered annuity program maintained by a tax-exempt charitable organization or certain educational institutions is not required to meet these nondiscrimination requirements. | (c) No provision. | (c)(1) *Coverage and nondiscrimination.*—Applies the coverage and nondiscrimination rules of present law (secs. 410(b) and 401(a)(4)) to the portion of any tax-sheltered annuity program attributable to contributions by the sponsoring employer. Directs the Secretary of the Treasury, in applying the coverage rules, to take into account the special circumstances faced by educational organizations and tax-exempt organizations (including the compressed salary scales of those organizations and the need of educational institutions to attract visiting professors). | (c)(1) *Coverage and nondiscrimination.*—No provision. |

XIV. PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)—Continued

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| c. *Nondiscrimination rules applicable to tax-sheltered annuities (cont.)* | | | (2) *Special rule for elective deferrals.*—Applies a special coverage and nondiscrimination rule to tax-sheltered annuity programs that permit elective deferrals; a tax-sheltered annuity program that permits elective deferrals will be considered discriminatory with respect to those deferrals unless the opportunity to make elective deferrals is made available to all employees of the entity sponsoring the tax-sheltered annuity program.<br>In applying the special test for deferrals, no employees of the entity sponsoring the tax-sheltered annuity program (other than nonresident aliens with no U.S.-source earned income) may be excluded from consideration.<br>(3) *Application to church plans.*—Exempts from the coverage and nondiscrimination rules tax-sheltered annuity programs maintained for church employees.<br>*Effective date.*—The provision is effective for plan years beginning after December 31, 1985. However, with respect to tax-sheltered annuity programs maintained by State and local governments, the provisions generally apply for plan years beginning after November 21, 1987. | (2) *Special rule for elective deferrals.*—No provision.<br>(3) *Application to church plans.*—No provision. |
| d. *Integration with Social Security* | (d) Under present law, a plan is not qualified unless contributions and benefits do not discriminate in favor of employees who are officers, shareholders, or highly compensated. A plan is not considered discriminatory merely because benefits provided under the plan bear a uniform relationship to compensation.<br>For purposes of determining whether benefits bear a uniform relationship to compensation, the employer-provided share of an employee's social security benefit may be taken into account. Under certain circumstances, the employer-provided share of social security benefits may be taken into account more than once under a defined benefit pension plan because an employer may reduce plan benefits by social security benefits earned with a prior employer. | (d) No provision. | (d) No provision. | (d) As described below, the rules governing the integration of a qualified plan with social security would be modified. |

## XIV. PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)—Continued

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| ***d. Integration, cont.*** | | | | |
| *(1) Defined benefit plans*<br>i. Excess plans | (1)(i) A defined benefit plan may be tested for discrimination in favor of highly paid employees by comparing the rate at which benefits are provided for pay in excess of a stated level (the integration level) with the rate at which benefits are provided for pay up to that level. If the difference is not more than 37½ percentage points (after adjustments), the plan will not be considered discriminatory.<br>For an employee who retires at age 65 in 1986, an excess plan could meet the nondiscrimination standard by providing benefits at the rate of 37½ percent of average pay in excess of $15,000 and no benefits with respect to the first $15,000 of pay. For younger employees, the integration level may be increased (up to $42,000). | | (1)(i) Provides that social security benefits earned with a prior employer are not to be considered in testing whether a defined benefit pension plan is considered discriminatory. | (1)(i) The rate at which benefits are provided for pay up to the integration level of a plan generally could not be less than 50 percent of the rate at which benefits are provided for pay in excess of that level. The integration level could not be more than the Social Security wage and benefit base ($42,000 for 1986).<br>To prevent discrimination, the 50 percent ratio could also be increased, under Treasury regulations, to reflect the value of specified plan features provided for benefits in excess of the integration level. The ratio could also be increased to prevent discrimination under a plan that provides for employee contributions with respect to pay not in excess of the Social Security wage and benefit base. |
| ii. Offset plans | (ii) A defined benefit offset plan may provide a benefit that is reduced (offset) by social security benefits considered to be provided to a plan participant from employer payments of the social security tax. A participant's plan benefit may be reduced by up to 83⅓ percent of the primary insurance amount provided under the Social Security Act. | | (ii) Provides that social security benefits earned with a prior employer are not to be considered in testing whether a defined benefit pension plan is considered discriminatory. | (ii) The offset could not reduce a participant's benefit by more than 50 percent. For example, the benefit before the offset was $200 per month, then the offset could not reduce the benefit below $100 per month.<br>The form of benefit, preretirement benefits, or similar plan provisions would not be taken into account in determining whether a plan integrates under the rules for offset plans. |
| *(2) Defined contribution plans* | (2) A defined contribution plan may be tested for discrimination in favor of highly paid employees by comparing the rate at which employer contributions are provided for pay in excess of a stated level (the integration level) with the rate at which employer contributions are provided for pay up to that level. If the difference is not more than the rate of the employer FICA tax for OASDI benefits under the Social Security Act, the difference will not cause the plan to be discriminatory.<br>For 1986, an integrated plan could provide employer contributions of 5.7 percent of pay in excess of $42,000 and no contributions for the first $42,000 of pay. | | (2) No provision. | (2) The rate at which employer contributions are provided for pay up to the integration level of a plan generally could not be less than 50 percent of the rate at which contributions are provided for pay in excess of that level. Also, the rate for pay in excess of the integration level could not exceed the rate for pay up to that level by more than OASDI tax rate (5.7 percent for 1986). The integration level could not be more than Social Security wage and benefit base ($42,000 for 1986). |
| | | | *Effective date.*—The proposal generally is effective for plan years beginning after December 31, 1985. | *Effective dates.*—Generally effective for plan years beginning after December 31, 1988. In the case of certain collectively bargained plans, the provision would not be effective until years beginning on or after the earlier of<br>(1) the termination of the collective bargaining agreement, or<br>(2) January 1, 1991. |

BEST COPY AVAILABLE

## XIV. PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)—Continued

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| *e. Top-heavy plans* | (e) Under present law, the benefit accrual rules generally applicable to qualified defined benefit plans do not apply to the minimum benefits required under a top-heavy plan. The fractional benefit accrual rule provides that each participant's accrued benefit at the end of any year must be at least equal to an amount determined by dividing the participant's years of participation by the total number of years of participation to normal retirement age. | (e) No provision. | (e) Applies a uniform benefit accrual rule in testing whether a qualified defined benefit plan is top heavy. In determining whether a plan is top heavy, the fractional benefit accrual rule is applied.<br>*Effective date.*—The provision is effective for plan years beginning after December 31, 1985. | (e) Same as House bill.<br>*Effective date.*—The provision would be effective for plan years beginning after December 31, 1986. |
| *f. Includible compensation* | (f)(1) *Qualified plans.*—Under present law, in the case of a qualified plan that is not top heavy, there is no limit on the amount of the annual compensation of an employee that may be taken into account under the plan. In the case of a qualified plan that is top heavy, the annual compensation of an employee taken into account under the plan may not exceed $200,000. | (f)(1) *Qualified Plans.*—No provision. | (f)(1) *Qualified plans.*—Limits the amount of compensation that may be taken into account under any qualified plan whether or not top-heavy. The limit for all qualified plans is 7 times the defined contribution dollar limit (under the bill for 1986, 7 times $25,000 or $175,000). The limit will be increased as the defined contribution plan dollar limit is increased. This limit applies for all purposes in testing for discrimination (secs. 401(a)(4) and 401(k)(3)). | (f)(1) *Qualified plans.*—Limit the amount of compensation that may be taken into account under any qualified plan, whether or not top-heavy. The limit for all qualified plans would be set initially at $200,000 and would be indexed by reference to percentage increases in the social security wage base. The limit applies for all purposes in testing for discrimination (e.g., secs. 401(a)(4) and 401(k)(3)). |
|  | (2) *SEPs.*—In the case of a simplified employee pension (SEP) the annual compensation of an employee taken into account under the plan may not exceed $200,000. | (2) *SEPs.*—No provision. | (2) *SEPs.*—No provision.<br>*Effective date.*—Generally effective for years beginning after December 31, 1985. | (2) *SEPs.*—Same as present law, but the $200,000 amount would be indexed by reference to percentage increases in the social security wage base.<br>*Effective date.*—Generally effective for years beginning after December 31, 1986. |
| 2. Benefit forfeitures | Forfeitures in a money purchase pension plan may not be reallocated to remaining participants, but must be used to reduce future employer contributions or to offset plan administrative expenses. | The proposal would permit forfeitures to be reallocated to remaining participants.<br>*Effective date.*—The proposal would apply to plan years ending after December 31, 1985. | Same as President's proposal.<br>*Effective date.*—Same as President's proposal. | Same as President's proposal.<br>*Effective date.*—Same as President's proposal. |

## XIV. PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)—Continued

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **3. Vesting** | (a) *In general.*—Present law requires that a participant's benefits be vested<br>(1) upon attainment of normal retirement age;<br>(2) at all times in the benefit derived from employee contributions; and<br>(3) with respect to employer-provided benefits, at least as rapidly as under one of the following 3 alternative minimum vesting schedules:<br>(i) Under one of the schedules, full vesting is required upon completion of 10 years of service (no vesting is required before the end of the 10th year).<br>(ii) Under a second schedule, vesting begins at 25 percent after completion of 5 years of service and increases gradually to 100 percent after completion of 15 years of service.<br>(iii) The third schedule takes both age and service into account, but, in any event, requires 50-percent vesting after 10 years of service, and an additional 10-percent vesting for each additional year of service until 100-percent vesting is attained after 15 years of service. | (a) *In general.*—No provision. | (a) *In general.*—No provision. | (a) *In general.*—Require that a participant's employer-provided benefit under any qualified plan (other than a multi-employer plan) vest at least as rapidly as under one of the following 2 alternative vesting schedules:<br>(1) Under the first schedule, full vesting would be required upon completion of 5 years of service.<br>(2) Under the second schedule, vesting begins at 20 percent after completion of 3 years of service and increases by 20 percent for each subsequent year of service, until 100 percent vesting is obtained after 7 years of service. |
|  | (b) *Application to multi-employer plans.*—The vesting requirements apply to multi-employer plans. | (b) *Application to multi-employer plans.*—No provision. | (b) *Application to multi-employer plans.*—No provision. | (b) *Application to multi-employer plans.*—Require that a participant's employer-provided benefit under a multi-employer plan be 100 percent vested no later than upon the participant's completion of 10 years of service. |

XIV. PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)—Continued

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **3. Vesting (cont.)** | (c) *Top-heavy plans.*—For any plan year for which a qualified plan is top heavy, an employee's right to accrued benefits must become nonforfeitable at least as rapidly as under one of 2 alternative schedules.<br>(i) Under the first top-heavy schedule, a participant who has completed at least 3 years or service with the employer maintaining the plan must have a nonforfeitable right to 100 percent of the accrued benefit derived from employer contributions.<br>(ii) A plan satisfies the second alternative (6-year, graded vesting) if a participant has a nonforfeitable right to at least 20 percent of the accrued benefit derived from employer contributions at the of 2 years of service, 40 percent at the end of 3 years of service, 60 percent at the end of 4 years of service, 80 percent at the end of 5 years of service, and 100 percent at the end of 6 years of service with the employer. | (c) *Top-heavy plans.*—No provision. | (c) *Top-heavy plans.*—No provision. | (c) *Top-heavy plans.*—Retain present law. |
| | (d) *Class-year vesting.*—Special vesting rules also apply to "class year plans." A class year plan is a profit-sharing or stock bonus plan that provides for the separate vesting of employee rights to employer contributions on a year-by-year basis. The minimum vesting requirements are satisfied if the plan provides that a participant's right to amounts attributable to employer contributions with respect to any plan year are nonforfeitable not later than the close of the fifth plan year following the plan year for which the contribution was made. | (d) *Class-year vesting.*—No provision. | (d) *Class-year vesting.*—No provision. | (d) *Class-year vesting.*—Class-year vesting would be permitted if it met one of the 2 alternative permitted vesting schedules.<br>*Effective dates.*—Generally effective for plan years beginning after December 31, 1988. In the case of certain collectively bargained plans, the provision would not be effective until years beginning on or after the earlier of<br>(1) the termination of the collective bargaining agreement, or<br>(2) January 1, 1991. |

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **C. Withdrawal of Benefits**<br>**1. Uniform minimum distribution rules** | Tax-favored retirement arrangements are subject to certain minimum requirements concerning the timing and amount of before-death and after-death distributions. Under these rules, distribution of a participant's benefits must commence when the participant<br>(1) attains age 70½ or<br>(2) with respect to participants who are not 5-percent owners, the taxable year in which the participant retires, if later.<br>Distributions from an IRA are required to commence when the owner attains age 70½.<br>The first annual required distribution may be delayed until April 1 of the calendar year following the calendar year in which the individual attains age 70½ or retires, whichever is applicable.<br>A qualified plan failing to satisfy the minimum distribution rules may be disqualified. A 50-percent excise tax applies to amounts required to be distributed from an IRA that are not distributed. | The proposal would retain the present law rules relating to benefit commencement date and would subject all qualified plans, tax-sheltered annuities and IRAs to uniform minimum distribution rules. Certain simplifying modifications would be made to those rules.<br>Under the proposal, the uniform sanction for failure to satisfy the minimum distribution rules would be a nondeductible excise tax equal to 50 percent of the amount by which the minimum amount required to be distributed exceeds the amounts actually distributed. The recipient of the distribution would be primarily liable with a right, where appropriate, to recover the tax from the plan. The current disqualification sanction would be eliminated. | Same as the President's proposal, except that a uniform benefit commencement date applies to qualified plans, IRAs and tax-sheltered annuities. Distributions are required to commence no later than April 1 of the calendar year following the calendar year in which the participant attains age 70½. | Same as House bill, except that the provision requiring that distributions commence no later than April 1 of the year following the year in which a participant attains age 70½ would apply only to a participant who, during the year in which the participant attains age 70½ or any of the 4 preceding years, was a highly compensated employee.<br>The definition of highly compensated employee is the same as the definition for coverage and nondiscrimination purposes |
|  |  | *Effective date.*—The proposal generally applies for distributions made after December 31, 1985. | *Effective date.*—Same as the President's proposal, with an exception from the uniform commencement date for individuals who are not 5-percent owners and who have attained age 70½ by Janaury 1, 1988. | *Effective date.*—Effective for distributions made after December 31, 1986. |
| **2. Withdrawals before age 59½**<br>***a. Additional income tax on early withdrawals*** | (a) An additional income tax is imposed on certain early withdrawals from qualified plans with respect to five-percent owners who have not attained age 59½, unless the early withdrawal is made on account of the employee's disability or death. A similar tax also applies to early withdrawals made from an IRA. | (a) The proposal would conform the early withdrawal rules for qualified plans to the rules for IRAs. Thus, an additional income tax would apply to any participant in a qualified plan or tax-sheltered annuity who receives a distribution before age 59½, death or disability unless the distribution is made in the form of a qualifying annuity. | (a) Same as the President's proposal, subject to the following modifications: | (a) Same as House bill. |
|  | *Qualifying annuity.*—Present law does not provide an exception to the additional tax on early withdrawals for distributions in the form of a life annuity. | *Qualifying annuity.*—A qualifying annuity would be an annuity commencing after the participant attains age 50, payable as one of a scheduled series of substantially nonincreasing payments under<br>(1) an annuity for the life of the participant (or the joint lives of the participant and the the participant's beneficiary), or<br>(2) an annuity for a term certain of at least 180 months commencing upon retirement under the plan. | *Qualifying annuity.*—A qualifying annuity which is not subject to the additional income tax is an annuity commencing at any age and payable in substantially equal periodic payments (made not less frequently than annually) for the life of the participant (or the joint lives of the participant and the participant's beneficiary). | *Qualifying annuity.*—Same as House bill. |

## XIV. PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)—Continued

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| *a. Additional income tax on early withdrawals (cont.)* | *Rate of tax.*—The rate of tax under present law is 10 percent. | *Rate of tax.*—The rate of tax generally would be 20 percent of the amount includible in income. The tax would be reduced to ten percent if the distribution is made on account of<br>(1) the purchase of the individual's first principal residence,<br>(2) the payment of college expenses for a dependent of the individual, or<br>(3) unemployment during the period following the cessation of unemployment benefits. | *Rate of tax.*—The rate of tax is 15 percent of the amount includible in income. | *Rate of tax.*—Same as House bill. |
| *b. Tax-sheltered annuities* | (b) Withdrawals under a tax-sheltered annuity invested in a custodial account may not commence prior to the time an employee attains age 59½, dies, becomes disabled, separates from service, or encounters financial hardship. Other tax-sheltered annuities are not subject to these withdrawal restrictions or the ten-percent additional income tax on early distributions. | (b) The proposal would eliminate financial hardship as a ground for distributions from tax sheltered annuities invested in custodial accounts and would extend the modified withdrawal restrictions applicable to tax-sheltered annuities invested in a custodial account to all tax-sheltered annuities. | (b) Extends the withdrawal restrictions currently applicable to tax-sheltered custodial accounts to all tax-sheltered annuities. Withdrawals on account of hardship from a tax-sheltered annuity or custodial account are permitted only to the extent of contributions made pursuant to a salary reduction agreement (but not earnings on those contributions). The present-law standards defining "hardship" for purposes of a CODA apply. | (b) Same as House bill. |
| | | *Effective date.*—The provisions would apply for taxable years beginning after December 31, 1985. However, the early withdrawal restriction would not apply to annuities with respect to which no additional contributions were made after December 31, 1985. | *Effective dates.*—The provisions are generally effective for years beginning after December 31, 1985. The provisions relating to restrictions on distributions from tax-sheltered annuity or custodial accounts do not apply to amounts contributed to tax-sheltered annuities or custodial accounts before December 31, 1985.<br>The bill contains exceptions to the tax on early withdrawals for<br>(1) individuals who, as of November 6, 1985, separated from service and commenced receiving benefits pursuant to a written election designating a specific schedule of benefit payments, and<br>(2) total distributions of a participant's accrued benefit on account of a plan termination before December 31, 1985. | *Effective dates.*—Effective for years beginning after December 31, 1986. The provisions relating to restrictions on distributions from tax-sheltered annuity or custodial accounts do not apply to amounts contributed to tax-sheltered annuities or custodial accounts before December 31, 1986.<br>Provides an exception to the tax on early withdrawals for individuals who, as of March 1, 1986, separated from service and commenced receiving benefits pursuant to a written election designating a specific schedule of benefit payments. |

## XIV. PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)—Continued

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **3. Uniform tax treatment of distributions**<br>***a. Rollovers*** | (a) Under certain circumstances, distributions from a qualified plan may be rolled over, tax-free, to another qualified plan or IRA. Special rules govern the extent to which distributions from particular plans may be rolled over, as well as the types of plans to which rollovers may be made.<br>In general, these rules are designed to prevent individuals from avoiding restrictions or becoming entitled to additional tax benefits by shifting money between plans. | (a) The proposal would permit all distributions (other than required minimum distributions) to be rolled over to other tax-favored retirement arrangements, effective for distributions after December 31, 1985. | (a) Retains present-law rollover restrictions. | (a) Retain present law. |
| ***b. 10-year forward income averaging and pre-1974 capital gains treatment*** | (b)(1) *Averaging.*—Certain lump sum distributions received under a qualified plan may qualify for special 10-year forward averaging treatment. | (b)(1) *Averaging.*—The proposal would repeal the special 10-year forward averaging treatment. | (b)(1) *Averaging.*—Substitutes 5-year for 10-year forward averaging and permits only one election of forward averaging with respect to a single lump sum distribution after the individual attains age 59½ (except as provided under the transition rule). Effective for taxable years beginning after December 31, 1985. | (b)(1) *Averaging.*—Same as House bill, effective for taxable years beginning after December 31, 1986. |
| | (2) *Capital gain.*—A participant may elect to treat the pre-1974 portion of any lump sum distribution as long-term capital gain. | (2) *Capital gain.*—The proposal would repeal the special pre-1974 capital gain treatment. | (2) *Capital gain.*—Phases out the pre-1974 capital gain treatment over a 6-year period beginning on January 1, 1986. | (2) *Capital gain.*—Same as House bill, effective on January 1, 1987. |
| | | *Transition rule.*—However, the repeal of capital gain treatment and 10-year forward averaging would be phased in over a 6-year period for individuals who will have attained age 55 before January 1, 1987. During the transition period, 10-year forward averaging calculations would use the present-law rate schedules. | *Transition rule.*—Any participant who attained age 50 by January 1, 1986, is permitted:<br>(1) to make one election of forward averaging with respect to a single lump sum distribution received before age 59½, and<br>(2) to retain the pre-1974 capital gain treatment for such a distribution under the 6-year phase out.<br>An individual who separates from service during December 1985 and receives a lump sum distribution in January or February of 1986 may elect to treat the distribution as if it were received in 1985, so that it could qualify for 10-year forward averaging, and capital gain treatment, if that treatment would have been applicable to a 1985 distribution. | *Transition rule.*—Any participant who attained age 50 by January 1, 1986, is permitted:<br>(1) to make one election of forward averaging with respect to a single lump sum distribution received before age 59½, and<br>(2) to retain the pre-1974 capital gain treatment for such a distribution under the 6-year phase out. |

## XIV. PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)—Continued

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| *c. Net unrealized appreciation* | (c) If an employee receives a lump sum distribution that includes employer securities, only an amount equal to the plan's basis in the securities is currently includible in income. Recognition of the net unrealized appreciation is deferred until the securities are sold or exchanged.<br>In addition, to the extent any distribution consists of employer securities attributable to employee contributions, recognization of the net unrealized appreciation is deferred until the securities are sold or exchanged. | (c) The proposal would repeal the provisions permitting deferred recognition of net unrealized appreciation, effective for distributions after December 31, 1985.<br>However, the repeal of net unrealized appreciation would be phased in over a 6-year period for individuals who will have attained age 55 before January 1, 1987. | (c) Retain present law. | (c) Retain present law. |
| *d. Constructive receipt* | (d) Under a tax-sheltered annuity, unlike a qualified plan, a participant is taxed when benefits are received or made available. | (d) The proposal would tax participants under a tax-sheltered annuity only when benefits are received, effective for distributions after December 31, 1985. | (d) Same as President's proposal. | (d) Same as President's proposal. |
| *e. Basis recovery* | (e)(1) *Pre-annuity starting date.*—Distributions prior to the annuity starting date are treated as being made first out of nontaxable employee contributions and then out of taxable amounts (employer contributions and income). | (e)(1) *Pre-annuity starting date.*—With respect to distributions before the annuity starting date, the proposal would reverse the ordering rules—treating the distributions as being made first out of taxable amounts (employer contributions plus interest) and then out of nontaxable employee contributions. | (e)(1) *Pre-annuity starting date.*—Same as President's proposal. | (e)(1) *Pre-annuity starting date.*—Same as President's proposal. |
| | (2) *Post-annuity starting date.*—Distributions after the annuity starting date are treated under the following rules:<br>(1) In general, each payment is treated as part a payment of income and part a recovery of employee contributions.<br>(2) Under a special rule, if an individual will receive all employee contributions within the first three years after the annuity starting date, then all distributions are considered a return of employee contributions until the individual's basis has been recovered. | (2) *Post-annuity starting date.*—The proposal would repeal the special 3-year basis recovery rule and treat each distribution as part of a payment of income and part as recovery of employee contributions, under modified basis recovery rules. | (2) *Post-annuity starting date.*—Same as President's proposal. | (2) *Post-annuity starting date.*—Same as President's proposal. |
| *f. Effective date* | | (f) *Effective dates.*—The provisions generally would apply to distributions made after December 31, 1985.<br>In addition, the basis recovery rule applicable to distributions made before the annuity starting date would not apply to benefits accrued prior to January 1, 1986. The repeal of the 3-year basis recovery rule and the modification of the exclusion ratio would not apply to any amount received as an annuity if the annuity was in pay status on January 1, 1986. | (f) *Effective date.*—The provisions generally apply to distributions made after December 31, 1985. However, the basis recovery rule applicable to distributions made before the annuity starting date does not apply to benefits accrued prior to January 1, 1986. The repeal of the 3-year basis recovery rule does not apply to any individual whose annuity starting date is on or before July 1, 1986. | (f) *Effective dates.*—The basis recovery rule applicable to distributions made before the annuity starting date would apply to benefits accrued after December 31, 1986.<br>The repeal of the 3-year basis recovery rule would be effective with respect to an individual whose annuity starting date is after January 1, 1987. If the annuity starting date is after January 1, 1987, but on or before January 1, 1988, 50 percent of the basis would be recovered under the 3-year rule, and the remaining 50 percent would be recovered under the new basis recovery rule. |

## XIV. PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)—Continued

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **4. Loans under qualified plans**<br>***a. Amounts treated as distributions*** | (a) Subject to certain exceptions, a loan to a participant from a qualified plan is treated as a taxable distribution of plan benefits. An exception is provided to the extent that the loan, when added to the outstanding balance of all other plan loans, does not exceed the lesser of<br>(1) $50,000, or<br>(2) the greater of $10,000 or one-half the participant's accrued benefit. | (a) Under the proposal, a loan would be treated as a distribution to the extent that the loan (when added to any outstanding balance) exceeds the lesser of—<br>(1) $50,000, reduced by the highest outstanding loan balance during the prior 12 months, or<br>(2) the greater of $10,000 or one-half of the employee's accrued benefit. | (a) Same as President's proposal. | (a) Same as President's proposal. |
| ***b. Repayment period*** | (b) The exception applies only if the loan must, by its terms, be repaid within five years, or within a reasonable period if the loan is used to acquire or improve a personal residence of the participant or family member. | (b) The proposal provides an exception to the five-year repayment period only for those loans applied to the first-time purchase of the participant's principal residence. | (b) Provides an exception to the 5-year repayment period only for those loans applied to the purchase of the participant's principal residence (whether or not a first-time purchase). Requires that a plan loan be amortized in level payments, made not less frequently than quarterly over the term of the loans. | (b) Same as President's proposal, except that the exception would not be limited to first-time purchases and would be available to descendants of the participant. |
| ***c. Interest paid on plan loans*** | (c) Interest paid on a loan from a qualified plan is deductible. | (c) No provision. | (c) Defers the deduction for interest paid by<br>(1) all employees with respect to loans secured by elective deferrals under a qualified cash or deferred arrangement or tax-sheltered annuity, and<br>(2) key employees with respect to loans from any qualified plan, by denying a deduction for the interest and increasing a participant's basis under the plan by the amount of nondeductible interest paid. | (c) No provision. |
| | | *Effective date.*—The provision would be effective for amounts received as a loan after December 31, 1985. | *Effective date.*—Same as President's proposal. | |

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **D. Tax Deferral Under Qualified Plans**<br>**1. Overall limits on contributions and benefits**<br>***a. Defined contribution plans*** | (a)(1) *Limits on contributions.*—Annual additions on behalf of a participant under a qualified defined contribution plan are limited to the lesser of (i) 25 percent of compensation, or (ii) $30,000. | (a)(1) *Limits on contributions.*—No provision. | (a)(1) *Limits on contributions.*—Reduces the dollar limit to the greater of $25,000 or 25 percent of the limit for defined benefit plans. | (a)(1) *Limits on contributions.*—The $30,000 limit on annual additions to a defined contribution plan would be frozen until the dollar limit on annual benefits under a defined benefit plan reaches $120,000. After that, the dollar limit for defined contribution plans would be indexed in the same manner as the dollar limit for defined benefit plans (by reference to percentage increases in the social security wage base) so that the ratio of the defined benefit plan dollar limit to the defined contribution plan dollar limit will remain at 4/1. |
| | (2) *Definition of annual additions.*—Annual additions include employer contributions, forfeitures, and if employee contributions exceed six percent of compensation, the lesser of (i) one-half the employee contributions, or (ii) total employee contributions in excess of six percent of compensation. | *Definition of annual additions.*—One-half of all employee contributions would be treated as annual additions. | (2) *Definition of annual additions.*—Treats all employee contributions as annual additions. | (2) *Definition of annual additions.*—All employee contributions would be treated as annual additions. |
| | | *Effective date.*—Limitation years beginning after December 31, 1985.<br>For collectively bargained plans, the modifications would apply to limitation years beginning after termination of the collective bargaining agreement. | *Effective date.*—Limitation years beginning after December 31, 1985.<br>For collectively bargained plans, the bill does not apply to years beginning before the earlier of<br>(1) the termination of the agreement, or<br>(2) January 1, 1991. | *Effective date.*—Limitation years beginning after December 31, 1986.<br>For collectively bargained plans, the bill does not apply to years beginning before the earlier of<br>(1) the termination of the agreement, or<br>(2) January 1, 1991. |

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| ***b. Defined benefit plans*** | (b)(1) *Limits on benefits.*—Annual benefits payable on behalf of a participant from a qualified defined benefit plan are limited to the lesser of (i) 100 percent of compensation or (ii) $90,000. | (b)(1) *Limits on benefits.*—No provision. | (b)(1) *Limits on benefits.*—Reduces the dollar limit for benefits commencing at age 62 to $77,000, indexed for inflation after 1987. Provides that the limit for benefits commencing at age 55 is not lower than $65,000. | (b)(1) *Limits on benefits.*—Same as present law, but limits the dollar limits by reference to the percentage increases in the social security wage base. |
| | (2) *Phase-in of limit.*—This limit is proportionately reduced for participants with less than ten years of service. | (2) *Phase-in of limit.*—The overall limit would be reduced for participants with less than ten years of plan participation. | (2) *Phase-in of limit.*—Same as President's proposal. | (2) *Phase-in of limit.*—Same as President's proposal. |
| | (3) *Special rule for police, firefighters, and pilots.*—None. | (3) *Special rule for police, firefighters, and pilots.*—No provision. | (3) *Special rule for police, firefighters, and pilots.*—The limit applicable to police and fire workers is not reduced below $50,000 at any age. For airline pilots, the limit at age 60 is $77,000. | (3) *Special rule for police, firefighters, and pilots.*—Same as House bill, except that, for pilots, the limit at age 60 is $90,000, indexed to the percentage increases in the Social Security wage base. |
| | (4) *Cost-of-living arrangements.*—No special rules. | (4) *Cost-of-living arrangements.*—No provision. | (4) *Cost-of-living arrangements.*—An employer would be permitted to offer employees a qualified cost-of-living arrangement that supplements benefits under a defined benefit pension plan. | (4) *Cost-of-living arrangements.*—Same as House bill. |
| | | *Effective date.*—The provision phasing in the requirement that the defined benefit plan dollar limit be reduced for participants with less than 10 years of participation would be phased in, becoming fully effective for years beginning after December 31, 1993. | *Effective date.*—Limitation years beginning after December 31, 1985.<br>For collectively bargained plans, the bill does not apply to years beginning before the earlier of<br>(1) the termination of the agreement, or<br>(2) January 1, 1991. | *Effective date.*—Limitation years beginning after December 31, 1986.<br>For collectively bargained plans, the bill does not apply to years beginning before the earlier of<br>(1) the termination of the agreement, or<br>(2) January 1, 1991. |

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| *c. Combined plan limit* | (c) The combined plan limit for an individual who participates in both a defined contribution plan and a defined benefit plan of the same employer is equal to the lesser of (i) 125 percent of the separate plan dollar limits, or (ii) 140 percent of the separate plan percentage limits.<br>A lower combined plan limit applies for individuals participating in a top-heavy plan. The limit is the lesser of (i) 100 percent of the otherwise applicable separate plan dollar limits, or (ii) 140 percent of the otherwise applicable separate plan percentage limits. In the case of a plan that is not super top-heavy, the lower combined plan limit does not apply if certain requirements are met. | (c) The combined plan limit for individuals who participate in both a defined contribution plan and a defined benefit plan of the same employer would be repealed for all nontop-heavy plans.<br>An additional excise tax would be imposed on all participants receiving annual benefits in excess of a specified amount. To the extent that aggregate annual distributions made with respect to any individual from qualified plans, IRAs, and tax-sheltered annuities exceed that dollar amount, an excise tax equal to ten percent of the excess would be imposed. Under the proposal, the dollar amount would be 1.25 times the defined benefit dollar limit (e.g., 1.25 times $90,000 would equal $112,500 for 1985 through 1987). | (c) Retains the combined plan limit.<br>Applies a 15-percent excise tax, rather than a 10-percent tax, on aggregate annual distributions from all tax-favored retirement arrangements in excess of the greater of<br>(1) $112,500 or<br>(2) 1.25 times the indexed dollar limit for defined benefit plans.<br>Applies a special higher ceiling for purpose of calculating the excess distribution for any calendar year in which the individual receives a lump distribution that is subject to long-term capital gains or 5-year averaging. The higher ceiling is the lesser of<br>(1) the portion of the lump sum that is eligible for capital gains treatment or 5-year averaging, or<br>(2) 5 times the otherwise applicable ceiling for such year.<br>The bill also contains a special rule for post-death distributions. In lieu of subjecting post-death distributions to the annual tax on excess distributions, the bill adds an additional estate tax equal to 15 percent of the individual's excess retirement accumulation. "Excess retirement accumulation" is defined as the excess of the decedent's interest in all tax-favored retirement arrangements over the present value of annual payments equal to the annual ceiling over a period equal to the life expectancy of the individual immediately before death. | (c) Same as House bill. |
| | | *Effective date.*—Years beginning after December 31, 1985. | *Effective date.*—Years beginning after December 31, 1985. | *Effective date.*—Years beginning after December 31, 1986. |
| *d. Tax-sheltered annuities* | (d) In the case of a tax-sheltered annuity, special one-time elections increase the overall defined contribution plan limit. The special elections allow certain catch-up contributions in a year, to the extent permitted by the section 403(b) exclusion allowance.<br>An additional election permits a church employee to elect to increase the overall limit by up to $10,000 for any year, not to exceed a lifetime amount of $40,000 for any employee.<br>The catch-up elections are available to employees of an educational organization, a hospital, a home health service agency, or a church, convention, or association of churches. | (d) The special catch-up elections would be repealed.<br>*Effective date.*—Years beginning after December 31, 1985. | (d) Retains special catch-up elections. | (d) The special catch-up elections would be retained and extended to employees of certain health and welfare services agencies.<br>*Effective date.*—Years beginning after December 31, 1986. |

| Item | Present Law | President's Proposal | House Bill | Finance Committee Staff Option |
|---|---|---|---|---|
| **2. Deductions for contributions to qualified plans**<br>***a. Profit-sharing and stock bonus plans*** | (a)(1) *Aggregate compensation limit.*—Employer contributions for a year not in excess of 15 percent of the aggregate compensation of covered employees are generally deductible for the year paid. | (a)(1) *Aggregate compensation limit.*—The proposal would modify the 15 percent of compensation limit to apply on an individual, rather than an aggregate, basis. Thus, the deductible contribution with repect to a particular employee could not exceed 15 percent of that employee's compensation. | (a)(1) *Aggregate compensation limit.*—No provision. | (a)(1) *Aggregate compensation limit.*—Retain present law. |
| | (2) *Coordination with social security integration.*—In the case of a profit-sharing or stock bonus plan that is integrated with social security, the limit on deductible employer contributions is not reduced by the employer share of social security taxes taken into account under the plan. | (2) *Coordination with social security integration.*—No provision. | (2) *Coordination with social security integration.*—In the case of a profit-sharing or stock bonus plan integrated with social security, reduce this limit by the employer share of social security taxes taken into account under the plan. | (2) *Coordination with social security integration.*—Retain present law. |
| | (3) *Limit carryforward.*—Employer contributions in excess of the deduction limits may be carried over and deducted in later years. If the contribution for a particular year is lower than the deduction limit, the unused limit may be carried over and used in later years. | (3) *Limit carry forward.*—The present-law carryforward for unused deduction limits would be repealed except under certain "retirement type" profit-sharing plans. A profit-sharing plan would be treated as a "retirement type" plan with respect to an individual if:<br>(1) the individual is an active participant in the plan;<br>(2) the individual is not a participant in any other profit-sharing or stock-bonus plan maintained by the employer;<br>(3) contributions are based on a formula using a reasonable year-of-service factor;<br>(4) certain benefits are not available before separation from service, death or disability; and<br>(5) the plan is not top-heavy. | (3) *Limit carryforward.*—Repeal the limit carryforward for all profit-sharing and stock bonus plans (including retirement-type plans). | (3) *Limit carryforward.*—Same as House bill. |

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| *b. Combination of pension and other plan* | (b) Employer contributions to a money purchase pension plan are generally deductible under rules applying to pension plans. The amount required under the minimum funding standard is the contribution rate specified by the plan, which cannot exceed 25 percent of a participant's compensation.<br>If an employer maintains a pension plan (defined benefit or money purchase) and either a profit-sharing or stock bonus plan for the same employee, then the employer's deduction for contributions for that year is generally limited to the greater of<br>(1) the amount needed to satisfy the minimum funding requirements of the pension plan or<br>(2) 25 percent of the aggregate compensation of covered employees. This limit does not apply when an employee participates in both a defined benefit and a money purchase pension plan of the same employer. | (b) The proposal would extend the 25-percent of aggregate compensation limit to all combinations of defined benefit and money purchase pension plans. | (b) Same as President's proposal. | (b) Same as President's proposal. |
| *c. Nondeductible contributions* | (c) Employer contributions in excess of the deduction limit may be carried over and deducted in later years. | (c) Employer contributions in excess of the deductible limits would be subject to a ten percent annual nondeductible excise tax until the excess is eliminated. | (c) Same as President's proposal. | (c) Retain present law. |
| | | *Effective date.*—The proposals generally would be effective for years beginning after December 31, 1985. Special transition rules would maintain certain limit carryforwards and permit the deduction of excess contributions carried forward from years before the effective date. | *Effective date.*—Same as President's proposal. | *Effective date.*—Effective for years beginning after December 31, 1986. |
| **3. Asset reversions under qualified plans** | Prior to the satisfaction of all liabilities with respect to employees and beneficiaries, assets held under a qualified plan generally may not be used for, or diverted to, purposes other than the exclusive benefit of employees. However, assets remaining in the plan upon plan termination generally may be paid to the employer after plan benefits, accrued to the date of the plan termination, have been provided.<br>Assets reverted to the employer are includible in the employer's gross income. | To recapture a portion of the tax benefits of deferral of tax on earnings on previously deducted plan contributions, the proposal would impose a nondeductible excise tax equal to 10 percent of the plan funds reverting to the employer upon plan termination.<br>*Effective date.*—The 10 percent recapture tax would apply to qualified plan assets reverting to an employer pursuant to a plan termination occurring after December 31, 1985. | Same as President's proposal.<br>*Effective date.*—Same as President's proposal. | Same as President's proposal.<br>*Effective date.*—Same as President's proposal. |

### XIV. PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)—Continued

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **E. Miscellaneous Pension and Deferred Compensation Provisions** | | | | |
| **1. Plan amendments not required until January 1, 1988** | If the requirements applicable to qualified plans are changed, present law generally requires that conforming plan amendments be adopted no later than the last day of the first plan year after the effective date of the change, and the amendments must be effective, for all purposes, not later than the first day of that plan year. | No provision. | Provides that a plan will not fail to be a qualified plan on account of changes made in the bill for any year beginning before January 1, 1988, provided—<br>(1) the plan complies, in operation, with the changes as of any separately stated effective date;<br>(2) the plan is amended to comply with the changes no later than the last day of the first plan year beginning after December 31, 1987; and<br>(3) the amendment applies retroactively to the first day of the first plan year beginning on or after the separately stated effective date.<br>In addition, collectively bargained plans will not fail to be qualified plans for any year beginning before the later of<br>(1) January 1, 1988, or<br>(2) the earlier of (a) January 1, 1991, or (b) the first plan year beginning after the termination of the collective bargaining agreement. | Provides that a plan will not fail to be a qualified plan on account of changes made before January 1, 1989, provided—<br>(1) the plan complies, in operation, with the changes as of any separately stated effective date;<br>(2) the plan is amended to comply with the changes no later than the last day of the first plan year beginning after December 31, 1988; and<br>(3) the amendment applies retroactively to the first day of the first plan year beginning on or after the separately stated effective date.<br>In addition, collectively bargained plans will not fail to be qualified plans for any year beginning before the later of<br>(1) January 1, 1989, or<br>(2) the earlier of (a) January 1, 1991, or (b) the first plan year beginning after the termination of the collective bargaining agreement. |
| **2. Discretionary contribution plans** | Under certain types of plans, including profit-sharing plans, the level of employer contributions to the plan may vary from year to year at the discretion of the employer. An employer's discretion over the level of contributions to a profit-sharing plan is limited by the requirement that the employer's contribution to the plan in any given year may not exceed the employer's current or accumulated profits. | No provision. | Employer contributions to a profit-sharing plan that satisfy the immediate vesting and withdrawal restrictions applicable to elective deferrals under a cash or deferred arrangement (CODA) are not limited to the employer's current or accumulated profits (whether or not the plan contains a CODA). | Employer contributions to a profit-sharing plan would not be limited to the employer's current or accumulated profits. |

XIV. PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)—Continued

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| 3. Requirement that collective bargaining agreement be bona fide | Under present law, many of the nondiscrimination standards of the Code applicable to qualified plans apply separately to plans or programs maintained pursuant to an agreement that is found to be a collective bargaining agreement if there is evidence that retirement benefits were the subject of good faith bargaining between the employer and employee representatives. Similar exclusions are provided with respect to certain welfare benefits provided to employees. Present law provides no clear definition of a collective bargaining agreement. | No provision. | No agreement is treated as a collective bargaining agreement unless it is a bona fide agreement between bona fide employee representatives and one or more employers.<br>*Effective date.*—Date of enactment. | Same as House bill.<br>*Effective date.*—Same as House bill. |
| 4. Penalty for overstatement of pension liabilities | A penalty may apply if deductions are based on a significant overstatement of the value of an item (such as a charitable deduction). The level of the penalty varies, depending on the degree of the overstatement. A similar penalty applies to underpayments of estate or gift tax due to valuation understatements. There is no current penalty for an overstatement of liabilities under a pension plan. | No provision. | Provides a new penalty on actuaries for underpayments of tax due to overstatements of liabilities under a pension plan. New penalty would be similar to the current overvaluation penalty.<br>*Effective date.*—Overstatements with respect to 1986 and later returns. | No provision. |

## XIV. PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)—Continued

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **F. Employee Benefits** | | | | |
| **1. Statutory employee benefit exclusions** | | | | |
| ***a. Exclusions from income*** | (a) *Exclusions from income.*—Present law provides specific income tax and employment tax exclusions with respect to the following benefits provided by an employer to employees. | (a) *Exclusions from income.*—The President's proposal would make the following changes in the tax treatment of employer-provided employee benefits. | (a) *Exclusions from income.*—The House bill makes the following changes in the treatment of employer-provided employee benefits. | (a) *Exclusions from income.*—The proposal would make the following changes in the treatment of employer-provided employee benefits. |
| *(1) Health benefits* | (1) Health benefits (whether or not insured). | (1) Employer contributions on behalf of an employee to a health plan would be partially includible in the employee's gross income. The amount included in income would be $10 a month for individual coverage and $25 a month for family coverage. | (1) Retains present law. | (1) Retain present law. |
| *(2) Group-term life insurance* | (2) The cost of up to $50,000 of group-term life insurance. | (2) The present-law treatment of group-term life insurance would be retained. | (2) Retains present law. | (2) Retain present law. |
| *(3) Death benefits* | (3) Up to $5,000 death benefits. | (3) The $5,000 exclusion for employer-provided death benefits would be repealed. | (3) Retains present law. | (3) Retain present law. |
| *(4) Prepaid legal services* | (4) Benefits under prepaid legal services plans (expired after 1985). | (4) The exclusion for prepaid group legal services would be made permanent. The exclusion would be available only to the extent that employer contributions to the plan are fixed before the beginning of the year for which benefits are provided. | (4) Extends the exclusion for prepaid legal services for 2 years through 1987. | (4) The exclusion would be made permanent. |
| *(5) Employer-provided transportation* | (5) Commuting through use of a van pool (expired after 1985). | (5) The exclusion for employer-provided transportation would be allowed to expire at the end of 1985, as scheduled under present law. | (5) Same as President's proposal. | (5) Same as President's proposal. |

## XIV. PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)—Continued

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **1. Statutory employee benefit exclusions (cont.)** | | | | |
| *(6) Employee educational assistance* | (6) Up to $5,000 annually of employee educational assistance (expired after 1985). | (6) The employee educational assistance exclusion would be made permanent. The $5,000 annual cap on educational assistance would be repealed. | (6) Extends the exclusion for educational assistance for 2 years through 1987 and retains the $5,000 cap on annual benefits. | (6) Same as the President's proposal, make the exclusion for employee educational assistance permanent, but provide that the cap on the annual exclusion equals ⅛ of the Social Security taxable wage base (⅛ × $42,000 = $5,250 for 1986). |
| *(7) Dependent care assistance* | (7) Dependent care assistance. | (7) Present law would be retained. | (7) Limits the exclusion for dependent care assistance to $5,000 a year ($2,500 for a married individual filing separately). | (7) Retain present law. |
| ***b. Self-employed individuals*** | (b) *Self-employed individuals.*—Under present law, a self-employed individual is not permitted to deduct (or exclude) the cost of health benefits, group-term life insurance, or cafeteria plan benefits. | (b) *Self-employed individuals.*—Present law would be retained. | (b) *Self-employed individuals.*—Retains present law. | (b) *Self-employed individuals.*—Permit self-employed individuals to deduct 50 percent of the amounts paid for health insurance through a nondiscriminatory employer-provided plan applicable to all trades or businesses of the self-employed individual (but not in excess of net earnings from self-employment), unless the health insurance is available through other employment of the self-employed individuals or such individual's spouse. |
| ***c. Effective date*** | | (c) *Effective date.*—Effective for taxable years beginning after December 31, 1985. | (c) *Effective date.*—Effective for taxable years beginning after December 31, 1985. | (c) *Effective dates.*—Effective for taxable years beginning after December 31, 1986, except that the provisions relating to prepaid legal services and employee eductional assistance would be effective for years after December 31, 1985. |

## XIV. PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)—Continued

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **2. Nondiscrimination requirements for employee benefit. Plans**<br>*a. General rule* | (a) Under present law, exclusions for most of the statutory employee benefits are conditioned on compliance with various rules prohibiting discrimination in favor of certain employees. Nondiscrimination rules are provided for<br>(1) group-term life insurance,<br>(2) self-insured medical reimbursement plans,<br>(3) qualified tuition reduction,<br>(4) group legal services,<br>(5) cafeteria plans,<br>(6) educational assistance,<br>(7) dependent care assistance,<br>(8) no-additional-cost services, qualified employee discounts, and subsidized eating facilities, and<br>(9) welfare benefit funds.<br>These nondiscrimination rules generally prohibit discrimination as to eligibility to participate and as to benefits provided. In addition, certain benefits are subject to concentration tests, which limit the exclusion if more than a specified percentage of total benefits are provided to certain owners. | (a) The President's proposal would establish uniform nondiscrimination rules for eligibility and benefits and a uniform concentration test for<br>(1) group-term life insurance,<br>(2) health plans (whether or not insured),<br>(3) group legal services,<br>(4) employee educational assistance,<br>(5) dependent care assistance,<br>(6) cafeteria plans,<br>(7) qualified employee discounts, no-additional-cost services, and subsidized eating facilities,<br>(8) qualified tuition reductions, and<br>(9) welfare benefit funds. | (a) Establishes uniform nondiscrimination rules as to eligibility and benefits for—<br>(1) group-term life insurance,<br>(2) health plans (whether or not insured),<br>(3) group legal services,<br>(4) educational assistance,<br>(5) dependent care assistance,<br>(6) cafeteria plans, and<br>(7) welfare benefit funds. | (a) The following modifications (as more fully described below) to the present-law nondiscrimination rules would be made:<br>(1) extend a nondiscriminatory benefits test to health plans (whether or not insured);<br>(2) establish a new uniform eligibility test for group-term life insurance and health plans (whether or not insured);<br>(3) apply a concentration test to group-term life insurance;<br>(4) establish, for all employee benefit plans, a uniform definition of highly compensated employees (i.e., employees in whose favor discrimination in prohibited); and<br>(5) establish, for all employee benefit plans, a uniform definition of employees who can be excluded from consideration in testing whether a plan is discriminatory; and<br>(6) With respect to all employee benefit plans, require that the employer provide reasonable notification to all eligible employees of their eligibility to participate in the plan. |
| | Present law does not provide a uniform definition of employees in whose favor discrimination is prohibited or of employees that can be excluded from consideration in testing whether a plan is discriminatory. | The proposal would establish a uniform definition of highly compensated employees (i.e., those employees in whose favor discrimination is prohibited) and of employees that can be excluded from consideration in testing whether a plan is discriminatory. | Establishes a uniform definition of highly compensated employees (i.e., those employees in whose favor discrimination is prohibited) and of employees that can be excluded from consideration in testing whether a plan is discriminatory. | |

## XIV. PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)—Continued

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| ***b. Definition of employees in whose favor discrimination is prohibited*** | (b) Under present law, benefits under the following plans may not discriminate in favor of officers, shareholders (or owners), or highly compensated employees:<br>(1) qualified tuition reductions,<br>(2) group legal services,<br>(3) educational assistance,<br>(4) dependent care assistance, and<br>(5) no-additional-cost services, qualified employee discounts, and subsidized eating facilities. | (b) The proposal would provide a uniform definition of highly compensated employees. An employee would be treated as highly compensated for a plan year if, at any time during the 3-year period ending on the last day of the plan year, the employee—<br>(1) owns an interest of at least one percent of the employer (determined with attribution rules);<br>(2) earns at least $50,000 in annual compensation from the employer; | (b) Provides a uniform definition of highly compensated employees, in whose favor discrimination is prohibited. Treats an employee as highly compensated if, at any time during the 2 preceding years, the employee is—<br>(1) a 5-percent owner;<br>(2) earns more than $50,000 annually; | (b) Provides a uniform definition of highly compensated employees, in whose favor discrimination is prohibited. An employee would be treated as highly compensated if, at any time during the preceding year, the employee—<br>(1) was a 5-percent owner;<br>(2) earned<br>(i) more than $100,000 (indexed by reference to the percentage increases in the social security wage base) or<br>(ii) more than $50,000 (indexed by reference to the percentage increases in the social security wage base) and is among the top 20 percent of employees by pay; or |
| | A group-term life insurance plan may not discriminate in favor of key employees, which includes—<br>(1) officers,<br>(2) top-10 owner-employees,<br>(3) 5-percent owners, and<br>(4) 1-percent owners who earn more than $150,000. | (3) earns at least $20,000 in compensation from the employer and is among (i) the top 10 percent of employees by compensation or (ii) the top 3 employees by compensation; or | (3) is in the top 10 percent of all employees by pay, excluding (i) employees who earn less than $20,000, and (ii) employees who earn less than $35,000 and are not among the top 5 percent by pay: or; | (3) was an officer (as defined in sec. 416(i). |
| | A self-insured medical reimbursement program may not discriminate in favor of<br>(1) the 5 highest paid officers,<br>(2) 10-percent shareholders,<br>(3) the 25-percent highest paid of all employees (excluding employees who may be excluded from consideration under the eligibility test). | (4) is a family member of another highly compensated employee for such year. | (4) family members of (i) 5-percent owners, and (ii) the top 10 highly compensated employees by pay. | Family members of 5-percent owners and of the 10 (by comparison) highly compensated employees are aggregated with the 5-percent owner or highly compensated employee and, therefore, are treated as a single-highly compensated employee. |
| | For purposes of the cafeteria plan nondiscrimination rules, a definition is provided for highly compensated individuals and for key employees. | | A family member is defined as a spouse, parent, lineal ascendant or descendant, and a spouse of lineal ascendant or descendant. | A family member is defined as a spouse, parent, lineal ascendant or descendant, and a spouse of a lineal ascendant or descendant. |
| | Highly compensated individuals include—<br>(1) officers,<br>(2) 5-percent shareholders,<br>(3) highly compensated employees, and<br>(4) spouses or dependents of such individuals.<br>Key employees include the same employees as provided for group-term life insurance. | Certain mechanical adjustments would be made to the top 10-percent and 3 highest-paid employees tests to take account an employer's salary structure. Similarly, adjustments would be provided to the 3-year lookback rule to reflect significant fluctuations in an employer's workforce. | "Highly compensated employees" also includes employees who are 5-percent owners during the current year, and employees who fall in categories (2) or (3) during the current year and who are also in the top 100 employees by pay during the current year. | "Highly compensated employees" also include employees who, for the current year, are 5-percent owners or employees in categories (2) or (3), if they are among the top-100 highly compensated employees by pay. |
| | Under a welfare benefit fund, a highly compensated employee means<br>(1) one of the 5 highest paid officers,<br>(2) 10-percent shareholders, and<br>(3) employees who are among the highest paid 10 percent of all employees (other than excludable employees). | | | The definition of "highly compensated employees" would apply for purposes of the nondiscrimination rules for—<br>(1) group-term life insurance,<br>(2) self-insured medical reimbursement plans,<br>(3) qualified tuition reduction,<br>(4) group legal services,<br>(5) cafeteria plans,<br>(6) educational assistance,<br>(7) dependent care assistance,<br>(8) no-additional-cost services, qualified employee discounts, and subsidized eating facilities, and<br>(9) welfare benefit funds. |

XIV. PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)—Continued

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| *c. Excludable employees* | (c) Under present law, for purposes of testing whether a plan is nondiscriminatory, certain employees can be disregarded.<br>In the case of a group legal services plan, educational assistance plan, or a dependent care assistance plan, employees covered under a collective bargaining unit may be disregarded if the benefit was the subject of good faith bargaining.<br>Under a group-term life insurance plan, the following employees may be disregarded:<br>(1) employees who have less than 3 years of service,<br>(2) part-time or seasonal employees,<br>(3) collective bargaining employees (if the benefit was the subject of good faith bargaining), and<br>(4) nonresident aliens.<br>Under a self-insured medical reimbursement plan, the following employees may be excluded from consideration:<br>(1) employees with less than 3 years of service,<br>(2) part-time and seasonal employees,<br>(3) employees who have not attained age 25,<br>(4) collective bargaining employees (if the benefit was the subject of good faith bargaining), and<br>(5) nonresident aliens.<br>For purposes of the cafeteria plan nondiscrimination rules, employees with less than 3 years of service may be disregarded.<br>Under a welfare benefit fund, the following employees may be disregarded:<br>(1) employees who have not completed 3 years of service,<br>(2) employees who have not attained age 21,<br>(3) seasonal or less than half-time employees,<br>(4) collective bargaining employees (if the benefits were the subject of good faith bargaining), and<br>(5) nonresident aliens. | (c) Certain classes of employees would be disregarded in applying the 125-percent eligibility test. Thus, under the proposal, the following employees need not be take into account in testing whether a plan provides nondiscriminatory coverage:<br>(1) if the plan so provides, employees with less than one year of service (30 or 90 days, in the case of an employer-maintained health plan),<br>(2) if the plan so provides, part-time and seasonal employees,<br>(3) employees covered by certain collective bargaining agreements, and<br>(4) nonresident aliens who have no U.S. earned income. | (c) The following employees could be disregarded in testing whether the nondiscriminatory eligibility test is satisfied:<br>(1) employees who have not completed 180 days of service;<br>(2) employees who work less than 20 hours per week;<br>(3) employees who normally work fewer than 1000 hours a year (seasonal employees);<br>(4) employees included in a collective bargaining unit if benefits were the subject of good faith bargaining;<br>(5) employees who have not attained age 21; and<br>(6) nonresident aliens. | (c) The following employees could be disregarded in testing whether the nondiscriminatory eligibility test is satisfied:<br>(1) in the case of health plans, employees who have not completed 180 days of service;<br>(2) in the case of a plan (other than health), employees who have not completed 1 year of service;<br>(3) employees who work less than half-time;<br>(4) employees who normally work fewer than 6 months a year (seasonal employees);<br>(5) employees included in a collective-bargaining unit if the benefits were the subject of good faith bargaining;<br>(6) employees who have not attained age 21; and<br>(7) nonresident aliens.<br>The definition would apply for purposes of the nondiscrimination rules for—<br>(1) group-term life insurance,<br>(2) self-insured medical reimbursement plans,<br>(3) qualified tuition reduction,<br>(4) group legal services,<br>(5) cafeteria plans,<br>(6) educational assistance,<br>(7) dependent care assistance,<br>(8) no-additional-cost services, qualified employee discounts, and subsidized eating facilities, and<br>(9) welfare benefit funds. |

## XIV. PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)—Continued

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| ***d. Rules for health plans*** | (d)(1) *Insured health plans.*—Under present law, no nondiscrimination rules apply to insured health plans. | (d)(1) *Insured health plans.*—The President's proposal provides a uniform eligibility, benefits, and concentration test applicable to all employee benefit plans.<br>*Eligibility test.*—Under the President's proposal, the percentage of highly compensated employees benefiting under a health plan could not exceed 125 percent of the percentage of all other employees benefiting under the plan. Under certain very limited circumstances in the case of compelling business reason (such as a merger), the IRS could waive the 125 percent test in favor of a more liberal test for a period of time. | (d)(1) *Insured health plans.*—The House bill provides a uniform eligibility and benefits test to all employee benefit plans, including insured health plans.<br>*Eligibility test.*—Under the eligibility test, 90 percent of all employees must be eligible to participate in a plan. In addition, a plan could not contain a provision relating to eligibility that discriminates in favor of highly compensated employees.<br>Under certain circumstances, the eligibility test may be applied separately with respect to employees in each separate line of business or operating unit of the employer. The bill requires that, in order, for the line of business exception to apply<br>(1) each line of business must have at least 100 employees, and<br>(2) at least 5 percent, but not more than 25 percent, of the employees in a line of business or operating unit are highly compensated. | (d)(1) *Insured health plans.*—The option would extend nondiscrimination requirements to insured health plans.<br>*Eligibility test.*—Under the eligibility test, plan must benefit at least—<br>(1) 80 percent of all employees, or<br>(2) a reasonable classification of employees that does not discriminate in favor of highly compensated employees.<br>The eligibility test would be applied by treating all employees of related employers (secs. 414 (b), (c), (m), and (o)) as employed by a single employer and would apply the employee leasing rules (sec. 414(n)).<br>However, the reasonable classification test could be applied separately to each line of business or operating unit of the employer. This separate application would be permitted if the following tests are met:<br>(1) each line of business or operating unit must be capable of being a separate self-sustaining unit;<br>(2) each line of business or operating unit must have at least 50 employees; and<br>(3) the percentage of highly compensated employees within any line of business or operating unit cannot be less than 50 percent or more than 200 percent of the percentage of highly compensated employees of the employer.<br>In addition, for purposes of applying the eligibility test, the aggregation of comparable health plans would be permitted. Health plans would be considered comparable if the average employer cost per employee in one plan does not vary significantly from the average cost in the other plan, taking into account differences in costs (determined under a specified index) for plans maintained in geographically dispersed areas. |

## XIV. PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)—Continued

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| *d. Rules for health plans (cont.)* | | *Benefits test.*—The proposal would require that all types and levels of benefits available to any highly compensated employee must be available to all nonhighly compensated participants. Similarly, any condition for receipt of a benefit would be required to be applied in a nondiscriminatory manner. | *Benefits test.*—The benefits test under the House bill requires that the coverage provided under a health plan be the same for each participant in the plan. A limited exception to this requirement is provided for employees who normally work fewer than 30 hours per week.<br>In addition, in the case of a health plan in which more than 25 percent of the participants are highly compensated, the plan is considered discriminatory unless—<br>(1) the plan actually covers at least 75 percent of those employees eligible to participate in the plan; or<br>(2) the plan, when aggregated with a comparable plan (or plans), satisfies the 25-percent test. Two or more plans are considered comparable if the average employer cost per participant in the plan or plans is at least 80 percent of the average employer cost per participant in a plan that would otherwise fail the nondiscrimination test. | *Benefits test.*—No separate benefits test is provided for insured health plans because the eligibility test also operates as a benefits test. |
| | | *Concentration test.*—Under the concentration test, the contributions provided to the top 20 (by pay) highly compensated employees could not exceed 25 percent of the total contributions provided under the plan for any year. | *Concentration test.*—No provision. | *Concentration test.*—No provision. |
| | (2) *Self-insured medical reimbursement plans.*—In the case of self-insured medical reimbursement plans, present law provides a nondiscriminatory eligibility test and a nondiscriminatory benefits test.<br>*Eligibility test.*—The eligibility test is satisfied if the plan—<br>(1) benefits 70 percent of all employees;<br>(2) benefits 80 percent of eligible employees and 70 percent of all employees are eligible; or<br>(3) benefits a nondiscriminatory classification of employees.<br>*Benefits test.*—Under the benefits test, the contributions or benefits provided may not discriminate in favor of highly compensated employees. | (2) *Self-insured medical reimbursement plans.*—Same as the rules for insured health plans. | (2) *Self-insured medical reimbursement plans.*—Same as the rules for insured health plans. | (2) *Self-insured medical reimbursement plans.*—Same as the rules for insured health plans. |

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| *e. Eligibility test for plans other than health plans* | (e) Under present law, the following benefits must be available to a classification of employees that does not discriminate in favor of officers, shareholders (or owners), highly compensated employees, or dependents of any such employees:<br>(1) qualified tuition reduction,<br>(2) educational assistance,<br>(3) dependent care assistance, and<br>(4) no-additional-cost services, qualified employee discounts, and subsidized eating facilities.<br>Group legal services plans, cafeteria plans, and welfare benefit funds must benefit (rather than merely be available to) a classification of employees that does not discriminate in favor of officers, shareholders, and highly compensated employees. A cafeteria plan maintained pursuant to a collective bargaining agreement is treated as nondiscriminatory.<br>A group-term life insurance plan must meet one of the following eligibility tests:<br>(1) the plan benefits 70 percent of all employees,<br>(2) at least 85 percent of the participants are not key employees,<br>(3) the plan benefits a nondiscriminatory classification of employees, or<br>(4) if the plan is part of a cafeteria plan, the requirements relating to cafeteria plans are met.<br>In applying the nondiscrimination tests to certain statutory fringe benefits, all employees of employers that are under common control are aggregated and treated as if employed by a single employer. | (e) Under the President's proposal, the percentage of highly compensated employees benefiting under a plan could not exceed 125 percent of the percentage of all other employees benefiting under the plan. Under certain very limited circumstances in the case of compelling business reason (such as a merger), the IRS could waive the 125 percent test in favor of a more liberal test for a period of time. | (e) Under the eligibility test, 90 percent of all employees must be eligible to participate in a plan. In addition, a plan could not contain a provision relating to eligibility that discriminates in favor of highly compensated employees.<br>Under certain circumstances, the eligibility test may be applied separately with respect to employees in each separate line of business or operating unit of the employer. The bill requires that, in order, for the line of business exception to apply<br>(1) each line of business must have at least 100 employees, and<br>(2) at least 5 percent, but not more than 25 percent, of the employees in a line of business or operating unit are highly compensated. | (e) Retain present law eligibility tests applicable to employee benefit plans other than group-term life insurance.<br>Establish an eligibility test for group-term life insurance plans under the same standards as the test that would apply to health plans. Under this eligibility test, the plan must benefit at least—<br>(1) 80 percent of all employees, or<br>(2) a reasonable classification of employees.<br>The aggregation rules of present law would be retained. However, the reasonable classification test would be clarified to provide guidance with respect to the circumstances under which the test could be applied separately to each line of business or operating unit of the employer. Separate application of the test would be permitted if the following conditions are met:<br>(1) each line of business or operating unit must be capable of being a separate self-sustaining unit;<br>(2) each line of business or operating unit must have at least 50 employees; and<br>(3) the percentage of highly compensated employees within any line of business or operating unit is not less than 50 percent or more than 200 percent of the percentage of highly compensated employees of the employer. |

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| *f. Benefits tests for plans other than health plans* | (f) Under present law, the contributions or benefits provided under a group legal services plan may not discriminate in favor of highly compensated employees.<br>Under a group-term life insurance plan, the type and amount of benefits available under the plan may not discriminate in favor of key employees. The test is satisfied if the benefits bear a uniform relationship to compensation.<br>A cafeteria plan may not discriminate in favor of highly compensated participants as to contributions or benefits, which requires that nontaxable benefits and total benefits (or employer contributions for total benefits) be nondiscriminatory. A special rule applies to health benefits.<br>Under a welfare benefit fund, the benefits provided under each class may not discriminate in favor of highly compensated employees. Life insurance, disability, severance pay, and supplemental unemployment compensation benefits are not considered nondiscriminatory merely because the benefits bear a uniform relationship to compensation. | (f) Under the President's proposal, all types and levels of benefits available to any highly compensated participant must also be available to all nonhighly compensated participants. Similarly, any condition for receipt to a benefit would be required to be applied in a nondiscriminatory manner.<br>The proposal would apply a nondiscriminatory benefits test to group-term life insurance, health benefits, and group legal services benefits provided under a permanent and enforceable plan. This test would apply whether or not the benefit was provided through insurance or self-insured by an employer. Certain benefits would be permitted to vary by compensation level.<br>Under the proposal, employee educational assistance benefits, dependent care assistance, miscellaneous fringe benefits, and qualified tuition reductions would also be subject to a nondiscriminatory benefits test under which the average amount of benefits provided to highly compensated employees could not exceed 125 percent of the average amount of benefits provided to other employees. In the case of educational assistance benefits, only amounts expended for degree programs would be required to be tested under this nondiscrimination rule. | (f) Requires that the coverage provided under a group-term life insurance plan or group-term legal services plan be the same for each participant in the plan, regardless of whether the benefit is provided through insurance or self-insured by the employer.<br>In the case of group-term life insurance plans and qualified legal services, 75 percent of all employees who are eligible to participate in the plan must actually be covered by the plan.<br>An educational assistance plan or dependent care assistance plan is considered discriminatory unless (a) all benefits available to highly compensated employees are available on the same terms and conditions to all other employees eligible to participate in the plan; and (b) the average benefit provides to nonhighly compensated employees is at least 80 percent of the average benefit provided to highly compensated employees. | (f) Retains present law benefits tests applicable to group-term life insurance, group legal services, cafeteria plans, and welfare benefit funds. |
| *g. Concentration tests for plans other than health plans* | (g) Under present law, not more than 25 percent of the benefits under a group legal services plan or a dependent care assistance plan may be provided during a year to 5-percent shareholders or owners (or their spouses or dependents).<br>No more than 25 percent of the nontaxable benefits under a cafeteria plan can be provided annually to key employees.<br>No more than 5 percent of the amounts paid or incurred under an educational assistance program may be provided annually for 5-percent shareholders or owners (or their spouses or dependents). | (g) The President's proposal would modify the utilization test of present law applicable to group legal services, employee educational assistance, and dependent care assistance. Under the modification, the contributions provided to the top 20 (by pay) highly compensated employees could not exceed 25 percent of the total contributions provided under the plan for any year. This rule would apply to each employee benefit otherwise excludable from income. | (g) Retains present law. | (g) Generally retain present law concentration tests. In addition, provide that no more than 25 percent of the benefits under a group-term life insurance plan may be provided to 5-percent owners. This rule would not apply if the plan provides equal coverage (in a dollar amount rather than as a percentage of pay) to each plan participant. |

### XIV. PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)—Continued

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| *h. Sanctions for discrimination* | (h) Under present law, if a plan fails to meet the applicable nondiscrimination requirements, all employees are required to include the value of the benefits provided in gross income. A special rule applies in the case of a discriminatory self-insured medical reimbursement plan under which only the highly compensated employees are required to include in income the portion of their reimbursements that are discriminatory. In the case of group-term life insurance, only key employees are required to include the value of the benefit in income under a discriminatory plan. | (h) Under the President's proposal, if a plan is found to be discriminatory in coverage, benefits, or utilization, the benefits provided to highly compensated employees would not be eligible for exclusion from gross income. The amount to be included in gross income in the case of insurance-type benefits would be the value of the coverage provided to a highly compensated employee and not reimbursements received under the plan for expenses. | (h) A highly compensated employee who is a participant in a discriminatory statutory fringe benefit plan is required to include in income an amount equal to the discriminatory portion of the employee's employer-provided benefit under the plan. | (h) A highly compensated employee who is a participant in a discriminatory fringe benefit plan would be required to include in income an amount equal to the employee's employer-provided benefit under the plan. No benefits would be includible in income for nonhighly compensated employees.<br>As in the President's proposal, the amount included in gross income in the case of insurance-type benefits is the value of coverage provided to a highly compensated employee. In the case of any other plan, an employee's employer-provided benefit is defined under the bill as the value of the benefit provided to or on behalf of the employee to the extent attributable to contributions made by the employer or pre-tax employee contributions. |
| *i. Reporting requirements* | (i) Under present law, an annual reporting requirement applies with respect to group legal services plans, educational assistance plans, and cafeteria plans. Under this requirement, each employer that maintains a plan is required to file a return showing the number of employees participating in the plan, the total cost of the plan for the taxable year, and specified employer identification information. | (i) Retains present law. | (i) Extends present-law reporting requirements to all employee benefit plans. In addition, the bill imposes a reporting requirement for any employee benefit plan in any year in which benefits are includible in the income of a key employee. The provision is effective for years beginning after December 31, 1986. | (i) Retains present law reporting requirements. |
| *j. Study* | | (j) No provision. | (j) Requires that the Treasury Department conduct a study of abuses of the health insurance provisions and make recommendations for changes in the nondiscrimination rules. No later than July 1, 1986, Treasury is required to report the result of the study, together with any recommendations it deems advisable, to the Committee on Ways and Means, the Committee on Finance, and the Joint Committee on Taxation. | (j) No provision. |
| *k. Effective dates* | | (k) The President's proposal relating to uniform nondiscrimination rules generally would be effective for plan years beginning after December 31, 1985, except that, in the case of a health plan, the proposal would be effective for plan years beginning after December 31, 1986. The proposal would provide a delayed effective date for collectively bargained plans. | (k) The provisions are effective for years beginning after December 31, 1986. | (k) Same as House bill. |

### XIV. PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)—Continued

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| 3. Benefits provided under a cafeteria plan | Under a cafeteria plan, an employee is offered a choice between cash and one or more fringe benefits. If certain requirements are met, then the mere availability of cash or certain permitted taxable benefits under a cafeteria plan does not cause an employee to be treated as having received the available cash or taxable benefits for income tax purposes.<br>A highly compensated employee is treated as having received available cash and taxable benefits if the cafeteria plan discriminates in favor of highly compensated individuals as to eligibility or as to benefits and contributions. In addition, if more than 25 percent of the total excludable benefits for a plan year are provided to employees who are key employees (certain officers and owners), then the key employees will be taxed as though they received all available taxable benefits under the plan.<br>In addition, each benefit provided under a cafeteria plan must separately satisfy any nondiscrimination rule applicable to that benefit. | The President's proposal would apply a special rule to reimbursements of medical, legal, or dependent care expenses under a reimbursement account, under which the reimbursements would be deemed to be nondiscriminatory if the average reimbursements for highly compensated employees does not exceed 125 percent of the average reimbursements for all other participants in the cafeteria plan. In addition, the contributions provided to the top 20 highly compensated employees could not exceed 25 percent of the total contributions under the plan for any year. Under the proposal, reimbursements of insurance premiums would not be permitted from a reimbursement account.<br>*Effective date.*—The President's proposal would be effective for plan years beginning after December 31, 1985. | Extends to cafeteria plans, for years beginning after December 31, 1986, nondiscrimination rules similar to those applicable to statutory fringe benefit plans. Also modifies the rule governing the year in which benefits under a discriminatory cafeteria plan must be included in income by highly compensated and key employees.<br>Clarifies that full-time life insurance salesmen may elect benefits under a cafeteria plan that they are otherwise permitted to exclude from income.<br>*Effective date.*—The proposal would be effective for taxable years beginning after December 31, 1986. | Retain present law, but modify the definition of highly compensated employees and excludable employees. |
| 4. Prizes and awards | (a) Prizes and awards received by the taxpayer, other than certain scholarships and fellowship grants, generally are taxable. However, there is an exception for awards received for achievements in fields such as charity, the arts, and the sciences, applying only if the recipient (i) has not specifically applied for the prize or award (e.g., by entering a contest), and (ii) is not required substantial services as a condition of receiving it. | (a) All prizes and awards (other than certain scholarships and fellowship grants) would be taxable. The present exclusion for awards for charitable, etc. achievement would apply only when the recipient designated that the prize or award go to a tax-exempt charitable organization. | (a) Same as President's proposal. | (a) Same as President's proposal. |
| | (b) Gifts are excludable from the income of recipients. To quality as a gift, an item must be given out of detached generosity and not as compensation or to benefit the donor. Business deductions for gifts are generally limited to $25 per recipient. However, for an employee award given by reason of length of service, productivity, or safety achievement that qualifies as a gift and as deductible, the deduction is limited to $400 or $1,600 (depending on the circumstances). | (b) Gift treatment would be denied for all employee awards given by reason of a work-related achievement. Since no employee awards would be both excludable and deductible, the deduction limits under present law would have no application. | (b) Same as President's proposal, with clarification that employee awards of low value (such as certain traditional retirement gifts) may qualify as both deductible and excludable under the rules for de minimis fringe benefits enacted in 1984 (sec. 132). | (b) Same as House bill. |
| | | *Effective date.*—Taxable years beginning after 1985. | *Effective date.*—Same as President's proposal. | *Effective date.*—Taxable years beginning after 1986. |

## XIV. PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)—Continued

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| 5. Accrued vacation pay | Under the present law, an accrual method taxpayer generally is permitted a deduction no earlier than the taxable year in which the all-events test is met and economic performance occurs. In the case of the deferred benefits for employees (such as vacation pay earned in the current taxable year, but paid more than 2½ months after the close of the current year), an employer generally is entitled to claim a deduction only when the benefit is includible in an employee's gross income.<br>Under a special rule of present law, an employer may make an election under section 463 to deduct an amount representing a reasonable addition to a reserve account for vacation pay (contingent or vested) earned by employees in the current year and expected to be paid by the close of that year or within 12 months thereafter. | No provision. | Revise the special provision under present law relating to accrued vacation pay to limit the deduction for accrued vacation pay to amounts expected to be paid during the current year or within 8½ months thereafter.<br>*Effective date.*—For taxable years of the employer beginning after December 31, 1985. | Same as House bill.<br>*Effective date.*—Years beginning after December 31, 1986. |
| 6. Faculty housing | Several court cases have held that on-campus housing furnished to faculty or other employees by an educational institution does not quality for the exclusion under Code section 119 (certain lodging furnished for the convenience of the employer), and that therefore the rental value of the housing (less any amounts paid by the employee) is includible in income and wages.<br>The Deficit Reduction Act of 1984 prohibited Treasury from issuing, prior to 1986, regulations treating as income the excess of the value of qualified campus lodging over the greater of<br>(1) the operating cost paid in furnishing the lodging, or<br>(2) the rent received, in the case of such lodging furnished in 1984 or 1985. | No provision. | No provision. | The rental value of qualified campus lodging for a year would be treated as no greater than five percent of the appraised value for the year of the lodging, provided that an independent appraisal is obtained by a qualified appraiser. Thus, the value of the lodging would be excluded from the employees' income and wages if the rent paid by him or her to the educational institution equals or exceeds (on an annualized basis) five percent of the appraised value. Also, rents charged by an educational institution to nonemployees for comparable lodging could be used to define fair rental value.<br>*Effective date.*—Taxable years beginning after 1985. For prior years, the IRS would follow the valuation rule, except that the assessed valuation of the property for local real estate tax purposes would be treated as meeting the requirement of a qualified appraisal. |

## XIV. PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)—Continued

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| 7. **Parents of airline employees; airline affiliate employees** | Under the Deficit Reduction Act of 1984, the value of "no-additional-cost" services provided by an employer for use by the employee, or the employee's spouse or dependent children, is excluded from income and wages if certain conditions are met, including a line-of-business limitation (Code sec. 132). | No provision. | (a) *Parents of employees.*—No provision. | (a) *Parents of employees.*—The value of the use of free or discounted airline passes by parents of an airline employee would be excluded from the employee's income and wages on the same basis as where such benefits are used by the employee's spouse or dependent children, effective January 1, 1985. |
| | | | (b) *Airline affiliates.*—The technical corrections provisions of the House bill provide that the value of the use of airline passes by certain individuals who are directly engaged in providing airline-related services to airlines or air transportation organizations are excluded from income and wages, on the same basis as in the case of airline service employees of an airline corporation. An individual is considered directly engaged in providing airline-related services if the individual performs services for an organization (in existence on September 12, 1984) that is a tax-exempt business league whose membership is limited to entities engaged in the transportation by air of individuals or property for compensation or hire.<br>Also, a grandfather exception is provided to the line-of-business limitation for tax-free treatment of airline passes furnished (after 1984) to individuals employed, as of September 12, 1984, by Pan American World Services, Inc. These provisions would be effective January 1, 1985. | (b) *Airline affiliates.*—Provide that the value of the use of airline passes by certain individuals who are directly engaged in providing airline-related services to airlines or air transportation organizations is excluded from income and wages, on the same basis as in the case of airline service employees of an airline corporation.<br>Also, a grandfather exception is provided to the line-of-business limitation for tax-free treatment of airline passes furnished (after 1984) to individuals employed, as of September 12, 1984, by Pan American World Services, Inc. These provisions would be effective January 1, 1985. |

## XIV. PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)—Continued

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **8. Health benefits for retirees** | Under present law, an employer generally is entitled to deduct contributions (within limits) to a welfare benefit fund to provide post-retirement medical benefits for employees. The limits allow amounts reasonably necessary to accumulate reserves under a welfare benefit plan so that funding of post-retirement medical benefits or post-retirement life insurance benefits (including death benefits) with respect to an employee can be completed upon the employee's retirement. However, these amounts may be accumulated no more rapidly than on a level basis over the working life of an employee with the employer of that employee.<br>Each year's computation of contributions with respect to retiree medical benefits is to be made under the assumption that the medical benefits provided to future retirees will have the same cost as medical benefits currently provided to retirees. Because the reserve is to be computed on the basis of current medical costs, future inflation is not taken into account. | No provision. | No provision. | (a) An employer would be permitted to take into account projected increases in medical costs in calculating the amount deductible for contributions to a welfare benefit fund for post-retirement medical benefits. The amount taken into account would be limited by reference to projected increases in medical costs under a specified index.<br>(b) Extend the due date of the study (mandated in DEFRA) relating to minimum standards for welfare benefit plans and a review of the funding levels of such plans to 1 year from the date of enactment of the bill. |

## XIV. PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)—Continued

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **G. Employee Stock Ownership Plans (ESOPs)**<br>**1. ESOPs as employee benefit plans**<br>***a. Investment in employer securities*** | (a) ERISA imposes a limit on the percentage of plan assets that may be invested in qualifying employer securities and qualifying real property. | (a) Under the proposal, no qualified plan could hold more than ten percent of plan assets in qualifying employer securities and qualifying employer real property. | (a) Retains present law relating to qualified plans. | (a) Retain present law. |
|  | For a pension plan (either defined benefit or money purchase), the limit is ten percent. For a profit sharing or stock bonus plan, the ten percent limit may be increased to an amount specified by the plan, up to 100 percent. | Under the proposal, a new Employee Stock Ownership Trust (ESOT) would be designed to invest primarily in employer securities. |  |  |
|  | An Employee Stock Ownership Plan (ESOP) (either a stock bonus plan or a combination stock bonus and money purchase pension plan) must be invested primarily in employer securities. ESOPs are subject to special qualification requirements in addition to the requirements generally applicable to qualified plans. | Under the proposal, any employer with 15 or more employees would be eligible to create a qualified ESOT. If the ESOT qualifies, then (1) the trust would be exempt from income tax, (2) employers would be allowed deductions (of up to 25 percent of compensation) for principal payments made on a securities acquisition loan, or for amounts contributed to an ESOT; even though participants would not be currently taxed on such contributions, and (3) participants would not be taxed until the employer securities were sold or exchanged. Parallel rules would be provided for certain nonleveraged ESOTs to which the employer had committed a stream of contributions.<br>All eligible securities acquisition loan would require either (a) annual principal payments not greater than 20 percent or less than 8.3 percent of the original principal balance, or (b) equal annual payments and a term of ten years or less.<br>The ESOT trust agreement would be required to provide that (1) the securities distributed or allocated during the year, and (2) dividends on undistributed and unallocated securities, be apportioned among all employees (or, those employees with 1000 hours of service) on the basis of each employee's compensation for the year not in excess of $50,000. |  |  |

## XIV. PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)—Continued

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| *b. Vesting* | (b) Under present law, ESOPs are subject to the vesting rules generally applicable to qualfied plans. | (b) No provision. | (b) Any ESOP that is not top heavy is required to provide that a participant's right to his account balance derived from employer contributions must become nonforfeitable no more slowly than the following 10-year graded vesting schedule: 20 percent vesting after completion of 6 years of service, and an additional 20-percent vesting for each additional year of service until 100 percent vesting is attained after 10 years of service. | (b) Retain present law. |
| *c. Nondiscrimination* | (c)(1) *In general.*—ESOPs are subject to the nondiscrimination rules applicable to qualified plans generally. These standards prohibit discrimination as to eligibility, contributions or benefits, in favor of employees who are officers, shareholders, or highly compensated employees. | (c)(1) *In general.*—No provision. | (c)(1) *In general.*—Requires that no more than one-third of the employer's contributions for a year may be allocated to the group of employees consisting of officers, 10-percent shareholders, or highly compensated individuals. Individuals are considered highly compensated if they have compensation in excess of 200 percent of the dollar limits on annual additions to a defined contribution plan (i.e., for 1985, 200 percent of $30,000, or $60,000). | (c)(1) Retain present law. |
|  | (2) *Compensation taken into account.*—For any year for which a qualified plan is a top-heavy plan, present law provides that only the first $200,000 of compensation may be taken into account under the plan for purposes of applying the nondiscrimination tests. | (2) *Compensation taken into account.*—The ESOT trust agreement would be required to provide that (1) the securities distributed or allocated during the year, and (2) dividends on undistributed and unallocated securities, be apportioned among all employees (or those employees with 1,000 hours of service) on the basis of each employee's compensation for the year not in excess of $50,000. | (2) *Compensation taken into account.*—Reduces the limit on includible compensation from $200,000 to an amount equal to 7 times the defined contribution plan dollar limit ($175,000 for 1986) and applies the limit to all plans, including ESOPs, whether or not top-heavy. | (2) Retain present law. |
| *d. Diversification* | (d) No provision. | (d) No provision. | (d) Requires that a "qualified employee" be entitled annually during the participant's "qualified election period" to direct diversification of up to 25 percent of the participant's account balance (50 percent after attainment of age 60). Any employee who has attained at least age 55 and completed 10 years of participation is a qualified employee. An employee's qualified election period commences with the year following the year in which the employee attains age 55 and completes 10 years of participation and end in the years following the year in which the participant attains age 60. The ESOP is required to offer at least 3 investment options, to provide an annual 90-day diversification election period and to complete the diversification within a specified period. | (d) Retain present law. |

## XIV. PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)—Continued

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| *e. Voting rights* | (e) A stock bonus or money purchase pension plan (including an ESOP) maintained by an employer whose securities are not publicly traded must provide the full pass-through of voting rights to participants with respect to securities allocated to such participants on major corporate issues if the plan holds more than ten percent of its assets in employer securities.<br>In addition, an ESOP maintained by an employer that has registration-type securities must provide pass-through voting with respect to allocated securities on any issue. | (e) Under the proposal, the new ESOT would be required to provide pass-through voting (1) on all issues with respect to allocated securities and (2) on major corporate issues with respect to unallocated securities. | (e) Requires that if an employer does not have registration-type securities, then (1) participants with more than 10 years of service have the right to direct the trustee to vote allocated securities on all issues, (2) participants with fewer than 10 years of service have the right to direct the trustee to vote allocated securities with respect to any corporate matter that must be decided by more than a majority vote. As under present law, no pass-through of voting rights is required with respect to unallocated securities.<br>Retains present-law requirements applicable to employers with registration-type securities. | (e) Retain present law. |
| *f. Special ESOP deduction limits* | (f) If an employer maintains an ESOP, contributions applied to the payment of principal on a securities acquisition loan are deductible up to 25 percent of covered compensation. | (f) The proposal would repeal the increased ESOP limits applicable to qualified plans. | (f) Retains present law. | (f) Retain present law. |
| | In addition, an employer's contributions to an ESOP that are applied to the payment of interest on a securities acquisition loan are deductible without regard to an annual percentage of compensation limit. | The proposal would permit a deduction not to exceed 25 percent of covered compensation for employer payments of principal on a securities acquisition loan. Nondeductible payments could be carried forward and deducted in subsequent years, subject to the same 25 percent limit.<br>This 25 percent deduction limit would be in addition to any deductions permitted for employer contributions to a qualified plan. | Clarifies that the special 25 percent of compensation limit only permits an employer maintaining a stock bonus ESOP to deduct principal payments of up to 25 percent of compensation without adopting a money purchase pension plan and does not increase the limit otherwise applicable to an employer who maintains an ESOP consisting of a combination stock bonus and money purchase pension plan. | |
| *g. Overall limits on contributions* | (g) The usual dollar limit on annual additions ($30,000) is increased to the lesser of (1) $60,000 or (2) the amount of employer securities contributed to, or acquired by, the plan. In addition, deductible ESOP contributions applied by the plan to the payment of interest on a securities acquisition loan, as well as forfeitures of certain employer securities, may be disregarded in applying this limit. | (g) The proposal would repeal the increased ESOP limits applicable under qualified plans. Allocations of employer securities under an ESOT would be permitted without regard to the qualified plan limits on annual additions. | (g) Retains present law. | (g) Retain present law. |
| | These increased limits apply only if the ESOP provides that no more than one-third of the employer contributions for the year are allocated to the group of employees consisting of officers, shareholders and highly compensated employees. | | | |

## XIV. PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)—Continued

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| *h. ESOP tax credits* | (h) An electing employer is allowed an income tax credit for contributions to a payroll-based tax credit ESOP. The credit is limited to one-half of one percent of compensation paid or accrued in 1985, 1986, or 1987. No credit would be allowed after 1987. | (h) The proposal would allow the payroll-based tax credit to expire after 1987, as scheduled under present law. | (h) Repeals the payroll-based tax credit, effective for compensation paid or accrued after December 31, 1985. | (h) Retain present law. |
| *i. Distribution restrictions* | (i)(1) *Put options.*—A participant in an ESOP generally must have the right to demand distribution of employer securities rather than cash and, if the securities are not readily tradeable, the employer must provide a put option. | (i)(1) *Put options.*—The proposal would repeal the special put option rules relating to qualified plans. | (i)(1) *Put options.*—Modifies the permissible period over which the plan may pay the option price to the participant. | (i)(1) Retain present law. |
|  | (2) *Distribution restrictions.*—Distributions from an ESOP generally must satisfy the distribution rules applicable to stock bonus or money purchase plans.<br>Under these rules, an ESOP is not required to make distributions to a participant, until the participant has attained normal retirement age. In addition, employer securities allocated to a participant's account under a tax-credit ESOP generally may not be distributed before the end of 84 months. | (2) *Distribution restrictions.*—The new ESOT generally would be required to distribute annually that portion of the securities held by the ESOT equal in value to the scheduled principal payments on the securities acquisition loan, as well as dividends paid on allocated and unallocated stock. Alternatively, the ESOT could retain nominal ownership of the allocated securities provided the employees had all rights of direct ownership.<br>In addition, the employer would be required to grant employees the right to put distributed or allocated securities within three years after receipt or allocation and for a specified period every year thereafter until the year following the employee's separation from service.<br>The 84-month rule would be repealed with respect to qualified plans. | (2) *Distribution restrictions.*—Requires that, unless an employee otherwise elects in writing, the payment of benefits from an ESOP must begin no later than 60 days after the end of the plan year in which occurs (1) the second anniversary of the date on which the participant separates from service, or (2) the first anniversary of the date on which the securities acquisition loan was repaid, if later. However, if the participant attains normal retirement age in an earlier year, benefits must commence no later than 60 days after the year in which the participant attains normal retirement age, absent a contrary election by the participant. | (2) Retain present law. |
| *j. Effective date* |  | (j) *Effective date.*—The President's proposal would generally apply to securities acquisition loans made after December 31, 1985. The treatment of additional contributions made pursuant to loans outstanding on December 31, 1985, would continue to be governed by existing law. | (j) *Effective date.*—Same as the President's proposal. |  |

## XIV. PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)—Continued

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| 2. Incentives for ESOP financing | | | | |
| *a. Deduction for dividends paid* | (a) An employer may deduct the amount of any dividends paid in cash with respect to employer-securities held by an ESOP and allocated to participants' accounts, provided the dividends are paid out currently to participants and beneficiaries. | (a) The proposal would modify the provision providing a deduction for dividends paid (1) by permitting the deduction only with respect to employer securities held by the new Employee Stock Ownership Trust (ESOT) (and not an ESOP); (2) by making the deduction available with respect to dividends paid on all allocated and unallocated employer securities held by the ESOT; and (3) by conditioning the deduction on the employer's making an additional nondeductible payment (equal to the resulting tax savings) to employees receiving the dividends. | (a) Repeals the present law provision effective for dividends paid after December 31, 1988. | (a) Retain present law. |
| *b. Exclusion of interest earned on securities acquisition loans* | (b) A bank, insurance company, or a corporation actively engaged in the business of lending money may exclude from gross income 50 percent of the interest received on loans to a leveraged ESOP, the proceeds of which are applied by the plan to acquire employer securities. | (b) The proposal would apply the 50-percent interest exclusion to transactions involving ESOTs rather than ESOPs, effective for loans made after December 31, 1985. | (b) Repeals the present law provision for loans made after December 31, 1988. | (b) Retain present law. |
| *c. Tax-deferred rollover of gain derived from sales of stock to an eligible employee organization* | (c) An individual may elect to defer recognition of gain on the sale of certain qualified securities to an ESOP or eligible worker-owned cooperative to the extent that the proceeds are reinvested in qualified replacement property within a replacement period. | (c) The proposal would permit an individual to elect to defer recognition with respect to qualifying sales made to an ESOT rather than an ESOP or eligible worker-owned cooperative, effective for sales occurring after December 31, 1985. | (c) Repeals the present law provision for loans made after December 31, 1988. | (c) Retain present law. |
| *d. Payment of estate tax by an employee organization* | (d) If qualified employer securities are (1) acquired from a decedent by an ESOP or an eligible worker-owned cooperative, (2) pass from a decedent to an ESOP or worker-owned cooperative or (3) are transferred by the decedent's executor to an ESOP or worker-owned cooperative, then the executor is relieved of estate tax liability to the extent the ESOP or cooperative is required to pay the liability. | (d) The proposal would repeal this provision, effective for decedents dying after December 31, 1985. | (d) Repeals the present law provision for decedent's dying after December 31, 1988. | (d) Retain present law. |

## XV. RESEARCH AND DEVELOPMENT

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **A. Expensing of R&E Expenditures; Incremental Research Tax Credit** | | | | |
| **1. Expensing** | A taxpayer may elect to deduct currently the amount of research and experimental expenditures incurred in connection with a business (sec. 174), notwithstanding the general rule that expenditures having a useful life beyond the current year must be capitalized. This expensing applies to "research and development costs in the experimental or laboratory sense."<br>The amount of the section 174 deduction is not reduced by the amount of the research credit. | Retain present law. | Retain present law. | Retain present law. |
| **2. Incremental tax credit** | *(a) Expiration date.*—Under present law, the credit does not apply to expenses paid or incurred after December 31, 1985. | *(a) Expiration date.*—The research credit would be extended for an additional three years, through December 31, 1988. | *(a) Expiration date.*—Same as President's proposal (three-year extension). | (a) *Expiration date.*—The credit would be made permanent. |
| | *(b) Structure.*—The taxpayer may claim a 25-percent tax credit for excess of (1) qualified research expenditures for the taxable year incurred in carrying on a business over (2) the average amount of the taxpayer's yearly qualified research expenditures in the preceding three taxable years. | *(b) Structure.*—Same as present law (25-percent incremental credit). | *(b) Structure.*—Same as present law (incremental credit), except that credit rate is reduced to 20 percent. | *(b) Structure.*—Same as present law (25-percent incremental credit). |
| | *(c) Research definition.*—The credit provision adopts the deduction definition of research (in sec. 174), but subject to three exclusions: (1) research conducted outside the U.S.; (2) research in the social sciences or humanities; and (3) research to the extent funded, through grant or contract, by another person or governmental entity. | *(c) Research definition.*—The definition of qualified research (for purposes of the credit) would be revised to limit the credit to research activities involving a process of experimentation intended to result in technological innovations in products and production processes. | *(c) Research definition.*—The committee report clarifies that the credit does not apply to expenditures for certain nonresearch activities (activities occurring after the beginning of production; adaptation of an existing product; and studies and surveys). In addition, the report modifies the definition of credit-eligible research (effective for taxable years beginning after 1985) to target the credit to research undertaken to discover information that is technological in nature and that pertains to functional aspects of products. | (c) *Research definition.*—Same as House bill, except that modifications would be reflected in statutory language. |
| | *(d) Qualified expenditures.*—Research expenditures eligible for the credit consist of (a) in-house expenditures for research wages and supples; (b) rental or user fees for research use of laboratory equipment, computers, or other personal property; (c) 65 percent of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf; and (d) 65 percent of a corporate taxpayer's expenditures (including grants or contributions) for basic research performed by universities or certain scientific research organizations. | *(d) Qualified expenditures.*—No provision. | *(d) Qualified expenditures.*—Leased research equipment is treated the same as purchased equipment; i.e., rental and similar payments for personal property (other than payments to others for use of computer time) are ineligible for the credit. | (d) *Qualified expenditures.*—Rental or user fees for research use of laboratory equipment, computers, or other personal property would remain eligible for the credit (as under present law). |

## XV. RESEARCH AND DEVELOPMENT—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **2. Incremental tax credit (Cont.)** | *(e) Credit use limitation.*—The research credit is not subject to the general limitation on use of business credits (85 percent of tax liability over $25,000). | *(e) Credit use limitation.*—No proposal. | *(e) Credit use limitation.*—The general limitation on business credits (75 percent of tax liability over $25,000) applies to the research credit.<br>*Effective date.*—Taxable years beginning after 1985. | *(e) Credit use limitation.*—Same as the House bill.<br>*Effective date.*—The provision making the credit permanent would apply to expenditures paid or incurred after 1985. The provisions relating to the research definition and credit use limitation would apply for taxable years beginning after December 31, 1986. |
| **3. Donations of scientific equipment** | Under a special rule, corporations are allowed an augmented charitable deduction for donations of newly manufactured scientific equipment to a college or university for research use in the physical or biological sciences. | Retain present law. | The category of eligible donees under the special rule is expanded to include certain tax-exempt scientific research organizations.<br>*Effective date.*—Taxable years beginning after December 31, 1985. | Retain present law. |
| **B. Allocation of Research Expenses to Foreign Source Income** | A suspended Treasury Regulation (sec. 1.861-8) rule requires taxpayers with foreign-source income from products in a product area in which the taxpayers do U.S. research to allocate part of their U.S. research expense against the foreign-source income. In 1981, the Congress suspended this rule for two years, so that all U.S. research expenditures generally offset U.S.-source income. In 1984, the Congress extended the moratorium for two additional years. | No provision. | The application of Reg. sec. 1.861-8, for the first two taxable years beginning after July 31, 1985, is modified as follows.<br>(1) Taxpayers may apportion automatically 50 percent of U.S.-incurred research expense to domestic income.<br>(2) The remainder is apportioned on the basis of gross sales or gross income.<br>*Effective date.*—Taxable years beginning after July 31, 1985. | Same as House bill, except that 75 percent of U.S.-incurred research expense would be allocated to domestic income.<br>*Effective date.*—Same as House bill. |

## XV. RESEARCH AND DEVELOPMENT—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **C. Personal Holding Companies** | (a) Personal holding companies are subject to a 50-percent tax on personal holding company income that is not distributed to shareholders. Generally, personal holding companies are corporations at least 50 percent of whose stock is owned by not more than five individuals and at least 60 percent of whose adjusted ordinary gross income is personal holding company income.<br>Personal holding company income includes computer software royalties, regardless of whether such royalties are received in connection with the active conduct of the trade or business of developing the software that generates the royalites. | (a) No provision. | (a) An exception from the definition of personal holding company income is provided for computer software royalties that are received by certain corporations that are actively engaged in the business of developing computer software. | (a) Same as House bill, except that the exception would be extended to foreign personal holding companies. |
| | (b) Personal holding company income also includes all gross interest income, regardless of whether such interest is received in connection with the active conduct of the business of brokering or dealing securities. | (b) No provision. | (b) Another exception is provided from the definition of personal holding company income for interest on securities held in the inventory of a dealer in securities. In addition, a dealer in securities may deduct interest on "offsetting loans" in computing interest income.<br>*Effective date.*—Royalties and interest received after December 31, 1985. | (b) No provision. |
| **D. University Basic Research Credit** | Expenditures eligible for the 25-percent incremental research credit (see A., above) include 65 percent of a corporate taxpayer's expenditures (including grants or contributions) for basic research performed by universities or certain scientific research organizations. | No provision. | A 20-percent tax credit applies to the *excess* of (1) 100 percent of corporate cash expenditures for university basic research *over* (2) the sum of (a) the greater of two fixed research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed base period, as adjusted for inflation.<br>*Effective date.*—Taxable years beginning after 1985. | Same as House bill. |

## XVI. REAL ESTATE PROVISIONS

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **A. At-Risk Rules** | The loss limitation at-risk rules limit the losses in excess of income with respect to an activity, which individuals and closely held corporations may deduct, to the amount the taxpayer has actually invested in the activity, including borrowed amounts to the extent the taxpayer is personally liable to repay or has pledged other non-financed property (except property used in the activity) as security, and has not borrowed the funds from a person with an interest in the activity other than as a creditor.<br>Closely held corporations engaged in certain equipment leasing activities and in certain active business activities are excepted from the rules.<br>The at-risk rules apply to all activities except the holding of real estate. | The exception for the activity of holding real estate would be repealed.<br>*Effective date.*—The proposal would apply to losses attributable to property acquired after December 31, 1985. | The bill applies the at-risk rules to real estate activities, with an exception treating third party nonrecourse debt secured by real estate used in the activity as an amount at risk.<br>*Effective date.*—The provision applies to losses attributable to property acquired after December 31, 1985. | Same as House bill.<br>*Effective date.*—The proposal will apply to losses attributable to property acquired after December 31, 1986. |
| **B. Tax Credit for Rehabilitation Expenditures**<br>**1. Nonhistoric structures** | The credit is 15 percent for nonresidential buildings at least 30 years old, and 20 percent for nonresidential buildings at least 40 years old. If the 15- or 20-percent credit is allowed, depreciable basis is reduced by the amount of credit earned. The credit is available only if the taxpayer elects to use the straight-line method of cost recovery with respect to rehabilitation expenditures.<br>Rehabilitation expenditures are eligible for the credit only if incurred in connection with a substantial rehabilitation in which either (i) 75 percent of external walls are retained in place as external walls, or (ii) 75 percent of external walls are retained in place as internal or external walls; 50 percent of external walls are retained in place as external walls; and 75 percent of the building's internal structural framework is retained in place. | The 15- and 20-percent credits would be repealed.<br>*Effective date.*—January 1, 1986. | Provide one 10-percent credit. Limit credit to buildings placed in service before 1936, and delete the alternative test that only looks to 75 percent of walls.<br>*Effective date.*—Property placed in service on or after January 1, 1986. | Same as House bill.<br>*Effective date.*—Property placed in service on or after January 1, 1987. |

## XVI. REAL ESTATE PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **B. Tax Credit for Rehabilitation Expenditures—Cont.** | | | | |
| **2. Certified historic structures** | The credit is 25 percent for certified historic structures. If the 25-percent credit is allowed, depreciable basis is reduced by 50 percent of the amount of credit earned. The credit is available only if the taxpayer elects to use the straight-line method of cost recovery with respect to rehabilitation expenditures.<br>The external-walls test of a substantial rehabilitation applies (as described above). | The credit for rehabilitations of certified historic structures would be repealed.<br>*Effective date.*—January 1, 1986. | Reduce credit to 20 percent, require a full-basis adjustment, and delete the external-walls tests.<br>*Effective date.*—Property placed in service on or after January 1, 1986. | Same as House bill.<br>*Effective date.*—Property placed in service on or after January 1, 1987. |
| **3. Transition rules** | No provision. | Credits would be allowed with respect to pre-effective date expenditures if pre-effective date expenditures plus post-effective date expenditures qualify under test of a substantial rehabilitation. | Credits would be available to buildings placed in service before January 1, 1994, if:<br>(a) rehabilitation completed pursuant to a written contract that was binding on September 25, 1985, or<br>(b) the building is acquired (or subject to a binding contract to be acquired) and either Part 1 or 2 of the Historic Preservation Certification Application has been submitted to the Interior Department or its designate, or the lesser of $1 million or 5 percent of rehabilitation's cost was incurred or required to be incurred pursuant to a binding contract entered into as of November 22, 1985, or the rehabilitation was completed pursuant to a written contract that was binding before November 23, 1985.<br>If a rehabilitation qualifies under (a) or (b), present law depreciation rules continue to apply (except full basis adjustment required for historic structures) and the credits are reduced from 15 percent to 10 percent, from 20 percent to 13 percent, or from 25 percent to 20 percent.<br>Special transitional rules are provided for five projects. | Credits described below would be available to buildings placed in service before January 1, 1994, if:<br>(a) rehabilitation completed pursuant to a written contract that was binding on March 1, 1986, or<br>(b) the building is acquired (or subject to a binding contract to be acquired) and either Part 1 or 2 of the Historic Preservation Certification Application has been submitted to the Interior department or its designate, or the lesser of $1 million or 5 percent of rehabilitation's cost was incurred or required to be incurred pursuant to a binding contract entered into as of March 1, 1986, or the rehabilitation was completed pursuant to a written contract that was binding as of March 1, 1986.<br>If a rehabilitation qualifies under (a) or (b), present law depreciation rules continue to apply (except full basis adjustment required for historic structures) and the credits are reduced from 15 percent to 10 percent, from 20 percent to 13 percent, or from 25 percent to 20 percent. |

## XVI. REAL ESTATE PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **C. Low-Income Housing**<br>**1. Five-year amortization of expenditures to rehabilitate low-income housing** | Taxpayers may elect to amortize over a 60 month period certain qualifying expenditures for additions or improvements to low-income rental housing with a useful life of at least five years (other than hotels or other similar facilities primarily serving transients). Expenditures in any year for any dwelling unit are eligible only if the aggregate amount of expenditures for each unit exceeds $3,000 over two consecutive taxable years. Expenditures for any dwelling unit are not generally eligible to the extent that they aggregate more than $20,000 (in certain cases, $40,000).<br>The election is scheduled to expire for expenditures incurred after December 31, 1986 (except in cases where rehabilitation began, or a binding contract for such expenditures was entered into, before January 1, 1987). | The election would be repealed. Expenditures for low-income housing would therefore be recovered in accordance with the applicable depreciation schedules.<br>*Effective date.*—The repeal would be effective for expenditures paid or incurred on or after January 1, 1986. | Retains present law with a modification: replace $20,000 and $40,000 aggregate expenditure limits with a single $30,000 limit.<br>*Effective date.*—The modification to the aggregate limit would apply to permit additional expenditures over the present $20,000 limit, in the case of expenditures paid or incurred on or after January 1, 1986.<br>*Transitional rule.*—The $40,000 limit would continue for expenses incurred:<br>(i) pursuant to a written contract that was binding as of September 25, 1985; or<br>(ii) with respect to rehabilitation commenced as of September 25, 1985; if 5 percent of the cost has been incurred or committed by that date;<br>provided in each case the additions or improvements are placed in service before January 1, 1988.<br>It would also continue in certain other circumstances. | Provision expires in accordance with present law. However, see credit for low-income rental housing, item C.2. below. |

## XVI. REAL ESTATE PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **2. Credit for low-income rental housing** | No low-income rental credit is provided but other special provisions are available:<br>*Tax-exempt bond financing*<br>Tax-exempt bonds may be used to finance multifamily rental housing if at least 20 percent (15% in targeted areas) of the housing units are occupied by individuals whose income does not exceed 80 percent of the area median income when they first occupy the unit. Treasury regulations require adjustments for family size in determining tenant income.<br>Multifamily rental housing bonds are exempt from volume caps and certain other requirements applicable to other IDBs.<br>(See Part XVII B.1.a i, below, for a discussion of rental housing bonds.) | No special provisions are available:<br>*Tax-exempt bond financing*<br>Tax-exempt bonds for rental housing would not be permitted. | No low-income rental credit is provided but other special provisions are available:<br>*Tax-exempt bond financing*<br>Tax-exempt bonds could be used to finance multifamily rental housing satisfying the following requirements:<br>One of the following set-aside requirements is satisfied on a continuous basis—.<br>(1) At least 25 percent of the housing units are occupied by persons whose income does not exceed 80 percent of the area median income, or<br>(2) At least 20 percent of the housing units are occupied by persons whose income does not exceed 70 percent of the area median income.<br>Multifamily rental housing bonds would be subject to the new unified volume cap and other requirements applicable to nongovernmental bonds. | As an alternative to tax-exempt bond financing and in lieu of preferential depreciation, five-year amortization, and special treatment of construction period interest and taxes, a credit having a present value equal to approximately 50 percent of the basis of low-income housing units in a project would be provided.<br>Under the option, each governmental unit authorized to issue multifamily rental housing bonds could elect to "trade-in" tax-exempt IDB volume authority and issue the new credits. A trade-in rate of 4.25 percent would be provided. Thus, for each $100 bond authority traded-in, a governmental unit could issue credits worth $4.25. The $4.25 of credits would be claimed annually over at least a 15-year period, but the present value of all credits could not exceed the 50-percent of basis limitation.<br>*Definition of low-income housing*<br>Low-income housing eligible for the credit would be defined as follows:<br>(a) At least 20 percent of the housing units in each project would have to be occupied by individuals having incomes of less than 50 percent of the area median income.<br>(b) Income determinations would be made with adjustments for family size.<br>(c) Qualification as a low-income tenant would be determined on a continuing basis.<br>(d) Rent charged to low-income tenants could not exceed 30-percent of the area income qualifying as low-income.<br>(e) The average basis of each housing unit against which the credits would be applied could not exceed the area median cost of construction for housing.<br>Newly constructed low-income housing projects would be eligible for the credit as would existing property that is substantially rehabilitated.<br>The cost of a substantial rehabilitation occurring during a period when credits were already being claimed by a project owner would be eligible for a credit in the same manner as newly acquired property.<br>Projects receiving the credit could not receive tax-exempt bond financing. |
|  | *Depreciation*<br>Low-income housing may be depreciated over 15 years using the 200-percent declining balance method; other buildings are limited to a 19-year recovery period and the 175-percent declining balance method.<br>(See Part II A.1., above for depreciation provisions). | *Depreciation*<br>Buildings, including low-income housing, would be depreciated over 28 years using a method equivalent to 112 percent declining balance. | *Depreciation*<br>Very low-income housing may be depreciated over 20 years using the 200-percent declining balance method. Other low-income housing may be depreciated over 30 years using the 200-percent declining balance method. Buildings other than low-income housing are depreciated over 30 years using the straight-line method. |  |
|  | *5-year amortization of rehabilitation expenditures*<br>Taxpayers may elect to amortize over a 60-month period certain qualifying expenditures for additions or improvements to low-income rental housing with a useful life of at least five years (other than hotels or other similar facilities primarily serving transients). Expenditures for any dwelling unit generally are not eligible to the extent that they aggregate more than $20,000 (in certain cases, $40,000). | *5-year amortization of rehabilitation expenditures*<br>The election would be repealed. Expenditures for low-income housing would be recovered in accordance with the applicable depreciation schedules. | *5-year amortization of rehabilitation expenditures*<br>Would retain present law with a modification replacing $20,000 and $40,000 aggregate expenditure limits with a single $30,000 limit. |  |

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **2. Credit for low-income rental housing (cont.)** | The election is scheduled to expire for expenditures incurred after December 31, 1986 (except in cases where rehabilitation began, or a binding contract for such expenditures was entered into, before January 1, 1987).<br>(See item 1., above, for further details of 5-year amortization provisions) | | | Property subject to depreciation transition rules would not be eligible for the credit unless 30-year straight-line depreciation was elected.<br>*Credit rate*<br>The maximum annual credit per project could not exceed 5 percent of the basis of low-income housing units in the project.<br>Subject to continuing compliance requirements, the credit would be received annually for at least 15 years. Longer periods would be permitted provided the present value of the credit did not exceed 50 percent of the basis of the low-income units.<br>The maximum amount of credit allowed with respect to each project (i.e., the number of housing units to be set-aside for low-income tenants) would be determined at the time the credit was allocated by the governmental unit (described below under credit administration).<br>The percentage of low-income housing units qualifying for credits could be increased in subsequent years, upon allocation of additional credit authority by the governmental unit.<br>The credits would be nonrefundable, but the present-law carryback and carryforward rules for the investment credit would apply.<br>*Compliance requirements*<br>Projects would be required to comply with the low-income occupancy requirement for at least 15 years.<br>Failure to meet the minimum low-income occupancy requirement during the 15-year period would trigger a recapture of the credit. The credit would be recaptured fully for violations during the first ten years, and recaptured partially for violations in years 11–15.<br>Failure to meet the low-income occupancy requirement upon which the maximum credit is based (while still satisfying the minimum low-income occupancy requirement) would result in a reduction of the credit for the year of the violation.<br>Loss of credits for non-compliance would occur only if apartment units became vacant; in such an event, each unit would be required to be rented to low-income tenants until the project was again in compliance. |
| | *Construction period interest and taxes*<br>Generally, interest paid or accrued on indebtedness incurred with respect to real property and real property taxes attributable to the construction period for such property, and real property taxes attributaduction, must be capitalized and amortized over a 10-year period. Interest and taxes related to low-income housing is not subject to this capitalization requirement. | *Construction period interest and taxes*<br>Interest and taxes attributable to the construction period of real property that is self-constructed, is held for sale in the ordinary course of business, or is constructed pursuant to a long-term contract, must be capitalized as part of the cost of the real property. There would be no exception for low-income housing. | *Construction period interest and taxes*<br>Same as President's proposal. | |

XVI. REAL ESTATE PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| 2. Credit for low-income rental housing (cont.) | | | | *Transferability*<br>Credits could be transferred to new purchasers of a project during the period for which the property is eligible to receive the credit, with the new purchaser "stepping into the shoes" of the seller, both as to credit percentage, basis, and liability for compliance and recapture.<br>*Administration of credit program*<br>Credits could be issued by a State or local governmental unit authorized to issue tax-exempt bonds for multifamily housing under State law.<br>Credit issuers would be permitted to charge reasonable fees to credit recipients similar to those permitted under the MCC program to cover the costs of the program.<br>*Coordination with other provisions*<br>The basis with respect to which credits were allowed would be reduced to reflect any rehabilitation credit for which the project was eligible.<br>Tax-exempt use property would not be eligible for the credit.<br>*Effective date.*—Effective for credits issued after December 31, 1986, pursuant to elections to trade in IDB authority for years beginning after December 31, 1986, for projects placed in service after that date. |
| D. Real Estate Investment Trusts<br>1. General requirements | An entity that qualifies as a real estate investment trust ("REIT") is subject to a corporate tax but is allowed a deduction for dividends paid to shareholders. To qualify as a REIT, an entity (1) must be taxable as a domestic corporation, (2) must have at least 100 shareholders, (3) must not have 50 percent or more of its stock held by five or fewer shareholders, (4) must distribute most of its income currently, (5) must hold a minimum percentage of its assets in real estate related and other passive assets, and (6) must derive minimum percentages of its income from such assets. A REIT is required to be a calendar year taxpayer unless it was in existence as a REIT for any taxable year beginning prior to October 4, 1976. | No provision. | No provision. | A taxpayer would be permitted to change its accounting year without consent in connection with its initial election of REIT status. An entity would not be disqualified from electing REIT status in the first taxable year of its existence because it was closely held. Partner to partner attribution would be ignored in determining if the REIT is closely held. Corporations that have never qualified as a REIT and that have earnings and profits accumulated as a regular corporation would be required to distribute accumulated earnings and profits in order to elect REIT status. |

## XVI. REAL ESTATE PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| 2. Asset and income requirements | In general, to meet the asset requirement, at the close of each quarter of the taxable year, at least 75 percent of the value of the REIT's assets must be represented by real estate assets, cash and cash items, and Government securities.<br>In general, to meet the income requirements, at least 75 percent of the REIT's gross income for the taxable year must be derived from rents on real property, interest on obligations secured by real property, gain from the sales of interests in real property (other than property held for sale in the ordinary course of a trade or business), dividends from a REIT, refunds of property taxes, and certain other limited sources. In addition, at least 95 percent of the REIT's gross income must be derived from these sources and interest or dividends or gains from the sale of securities. | No provision. | No provision. | REITs would be permitted to hold assets in wholly owned subsidiaries. REIT qualification tests would be applied on an entity wide basis (i.e., ignoring the separate corporate status of the subsidiaries).<br>For a one-year period after the receipt of new capital, income from the temporary investment of the new capital that qualifies as "95 percent income" would be treated as qualifying "75 percent income." |
| 3. Definition of rents | Rents from real property include rents from interests in real property and charges for services customarily furnished in connection with the rental of real property whether or not such charges are separately stated. Rents are not considered to qualify if services are provided other than through an independent contractor. In addition, rents are not considered to qualify if they are based on the net profits of the tenant. | No provision. | No provision. | REITs would be permitted to provide those services customarily furnished in connection with the rental of real property without being required to use independent contractors.<br>REITs would be permitted to receive rents based on the net income of the tenant, provided that the tenant's profits are derived only from sources that the REIT would be permitted to earn directly. |

## XVI. REAL ESTATE PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| 4. Distribution requirement | In general, the distribution requirement is satisfied if for the taxable year the REIT distributes 95 percent of its taxable income determined without regard to any capital gains recognized by the REIT. | No provision. | No provision. | Any income that is accrued but not received with respect to original issue discount on a loan or with respect to a deferred rental agreement, or any income that is recognized as the result of the failure of an exchange that the REIT intended in good faith but that was ultimately determined not to qualify for treatment as a tax-free like kind exchange, would not be subject to the distribution requirement to the extent that such amounts exceed 5 percent of the REIT's taxable income. The REIT would be required to pay tax on the undistributed amount.<br>The amount of a REIT's current earnings and profits would be not less than the REIT's taxable income for the purpose of determining whether a distribution was made out of earnings and profits. |
| 5. Capital gains | If the REIT has recognized any capital gain during a taxable year, the REIT is taxable on the amount of such gain unless it elects to pay a capital gain dividend.<br>The REIT may elect to pay a capital gain dividend by designating in a notice mailed to shareholders within 30 days of the end of the REIT's taxable year, that a portion of dividends paid during the taxable year are capital gain dividends. The portion so designated may not exceed the REIT's net capital gain recognized reduced by any net operating losses. Any dividend so designated is treated as a capital gain by the recipient shareholder. | No provision. | No provision. | REITs would be permitted to compute their net capital gain without offset for net operating losses. NOL's not used to offset capital gain income would be carried over according to the ordinary rules. REITs would be permitted to send capital gain notices to shareholders with the mailing of their annual report, rather than 30 days after year end. |

BLANK PAGE

BLANK PAGE

BLANK PAGE

## XVI. REAL ESTATE PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **6. Prohibited transactions** | A 100 percent tax is imposed on a REIT's net income from prohibited transactions. Losses from prohibited transactions are not deductible from gains on prohibited transactions and are not deductible in computing taxable income.<br>In general, a prohibited transaction is the sale of property held primarily for sale in the ordinary course of business. A safe harbor is provided whereby a sale of property is not treated as a prohibited transaction if such property has been held for at least four years (for the production of rental income if land and improvements), the aggregate expenditures during the four-year period preceding the date of sale that are includible in the basis of the property do not exceed 20 percent of the selling price of the property, and the sale is one of not more than five sales of property by the REIT during the taxable year. In general, the disposition of property acquired pursuant to a foreclosure is not treated as a prohibited transaction. | No provision. | No provision. | The number of sales that a REIT is able to make within the prohibited transaction safe harbor would be expanded from 5 to 7. An alternative safe harbor would be provided whereby a REIT may make any number of sales during a taxable year provided that the gross income from such sales does not exceed 15 precent of the REIT's taxable income for such year. The extent of improvements that a REIT is permitted to make would be increased from 20 percent to 30 percent of the property's adjusted basis. Any marketing or development would be required to be done through independent contractors. Losses from prohibited transactions would be permitted to offset taxable income but would not be permitted to offset gains from prohibited transactions. |
| **7. Deficiency dividends** | If it is determined that a REIT failed to satisfy the distribution requirement in a taxable year on account of a subsequent adjustment to its taxable income, then the REIT may avoid disqualification by the prompt distribution of a "deficiency dividend." A REIT for which such a deficiency is determined must pay interest on the deficiency as well as a penalty equal to the amount of interest not in excess of half of the amount of the deficiency. | No provision. | No provision. | The penalty tax under section 6697 on deficiency dividends would be eliminated. |
| **8. Effective date** | | | | *Effective date.*—Taxable years beginning after December 31, 1986. |

## XVII. TAX-EXEMPT BONDS

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **A. General Restrictions on Tax Exemption** | Interest on bonds issued by or on behalf of State and local governments the proceeds of which are to be used to finance government operations is tax-exempt. | Interest on bonds issued by or on behalf of State and local governments the proceeds of which are used to finance government operations would continue to be tax-exempt. | Same as present law. | Same as present law. |
| | Subject to exceptions below, interest on State and local government bonds is taxable if— | Interest on State and local government bonds would be taxable if more than 1 percent of the bond proceeds were used by any person other than a State or local governmental unit. | Subject to exceptions below, interest on State and local government bonds would be taxable if— | Subject to exceptions below, interest on State and local government bonds would be taxable if: |
| | (1) The bonds are *IDBs,* i.e.—<br>(a) More than 25 percent of the bond proceeds is to be used in a trade or business of a person other than a State or local government, or section 501(c)(3) organization (the "trade or business use" test), and | | (1) The greater of 10 percent or $10 million of proceeds is to be used by persons other than State or local governments; or | (1) The bonds were *IDBs,* defined as under present law, except—<br>(a) 10% trade or business use would be substituted for 25% and clarification would be provided that the nongovernmental use must be related to the governmental activities financed by the bonds; and |
| | (b) More than 25 percent of the repayment of the bonds is secured by or to be derived from property to be used in such a trade or business (the "security interest" test); or | | | (b) 10% or more of the repayment of the bonds is secured by or to be derived from property used in a trade or business, with clarification that direct or indirect payments to an issuer of the bonds made by a nongovernmental person with respect to bond-financed property would be treated as satisfying the security interest test whether or not formally pledged. |
| | Use of bond-financed property is treated as use of bond proceeds.<br>Use of bond-financed property or services by the general public is not treated as a private use if the property or services are available to all members of the general public on the same basis. (For example, the fact that one industrial customer uses more than 25% of a sewer system serving the general public does not result in the bonds being IDBs).<br>Management contracts, output contracts, take-or-pay contracts, and leases, as well as actual ownership of property, are examples of situations where all members of the general public do not use property or services on the same basis.<br>The determination of whether a management contract is treated as trade or business use is made on a facts and circumstances basis. | The President's proposal would treat use of bond-financed property or services on the same basis by all members of the general public as nongovernmental (i.e., taxable) use, but would treat such use as an exception to its governmental use rule. | Same as present law. | Liberalize present law to provide that use pursuant to management contracts not exceeding 5 years would not be treated as trade or business use *as long as* (a) compensation was not based on a share of *net profits,* and (b) the exempt owner has the option to cancel the contract at the end of any 3 year period. (This would allow contracts based on a flat fee, a share of gross revenues, or any other basis except net profits.) |

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **A. General Restrictions on Tax Exemption (cont.)** | The IRS has stated that, under certain specified conditions, it will issue an advance ruling that a facility managed by a private management company is *not* considered to be used in that company's trade or business. Such a ruling will be issued only if—<br>(i) the management services are provided in return for a reasonable, periodic flat fee, under a contract not exceeding 5 years' duration (including renewal options), with the exempt owner having the option to cancel the contract at the end of any 2-year period, or<br>(ii) in the case of certain newly operational facilities, compensation is based on a percentage of gross revenues from the facility, for a period which generally may not exceed one year.<br>To qualify under (i) or (ii) above, the owner of the facilities and the management company must not be subject to common control, with allowances for *de minimis* cases (Rev. Proc. 82-14, 1982-1 C.B. 459).<br>Similar principles are applied in determining whether advance rulings will be issued, where bond-financed hospitals or similar facilities are used by nonexempt individuals other than employees (e.g., use of public or charitable hospitals by private physicians) (Rev. Proc. 82-15, 1982-1 C.B. 460). | | | |
| | (2) The bonds are *private loan bonds,* i.e.—<br>(a) 5 percent or more of the bond proceeds is to be used to finance (directly or indirectly) loans to persons other than State or local governments or section 501(c)(3) organizations, and<br>(b) The bonds are not—<br>(i) IDBs, mortgage subsidy bonds, or student loan bonds for which tax-exemption specifically is provided in the Code, or | | (2) The greater of 5 percent or $5 million of proceeds is to be used to make loans to such persons.<br>The present law exception from the 5% loan rule for the Texas Veterans' Land Bond Program would be retained, and its sunset date deleted. | (2) The bonds were *private (e.g., consumer) loan bonds,* defined as under present law. (Present-Law exceptions would be retained, the sunset date on Texas Veterans' Land Bond Program would be deleted and an exception would be added for Iowa New Jobs Training Program, subject to a $100 million ceiling on outstanding bonds.) |

## XVII. TAX-EXEMPT BONDS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **A. General Restrictions on Tax Exemption (cont.)** | (ii) Tax Assessment Bonds (bonds used to make loans (other than for use in a trade or business) to finance governmental taxes or assessments of a general nature and for an essential governmental function).<br>An exception to the 5% rule is provided for the Texas Veterans' Land Bond program and an Oregon energy conservation program. The exception for the Texas program is limited to bonds issued before March 15, 1987. | | Tax Assessment Bonds, defined as under present law (except expanded to permit loans to persons engaged in a trade or business), would be treated as governmental (i.e. tax-exempt) bonds. | Tax Assessment Bonds would be treated in the same manner as under the House bill. |
| | | | | (3) *Bonds for qualified governmental facilities.*—The 10-percent trade or business use test and the 10-percent security interest test would be increased to 25 percent for bonds for qualified governmental facilities if the bonds were principally (whether or not exclusively) secured by a pledge of full faith and credit by a governmental unit with general taxing powers.<br>Qualified governmental facilities would be—<br>(a) Public schools (including universities);<br>(b) Prisons and jails;<br>(c) Courthouses and statehouses;<br>(d) Highways, bridges, and tunnels; and<br>(e) State and county government general hospitals.<br>(*See also* item C., below, for special rules for IDBs for qualified public sewage, solid waste disposal, and water facilities.) |
| | Exceptions are provided permitting tax-exemption for interest on bonds to finance certain specified private activities, discussed below. | No exceptions would be provided for bonds to finance specified activities or for bonds for section 501(c)(3) organizations. Instead, interest on nongovernmental bonds would be tax-exempt only where the nongovernmental use occurred solely because—<br>(i) Bond-financed property was leased to a person other than a State or local government for an initial period not exceeding 1 year after its completion; or<br>(ii) Bond-financed property was operated by a person other than a State or local government pursuant to a management contract the term of which did not exceed 1 year. | Exceptions from the governmental use requirement would be provided as under present law for certain nongovernmental activities, discussed in B, below, including certain activities of section 501(c)(3) organizations. | Exceptions similar to present law would be provided permitting tax-exempt financing for specified private activities, as discussed in item B., below. |

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **A. General Restrictions on Tax Exemption (cont.)** | | | *Effective date.*—Bonds issued after December 31, 1985.<br>*Exceptions.*—(1) Obligations with respect to facilities—<br>(a) The original use of which commences with the taxpayer and the construction, reconstruction, or rehabilitation of which began before September 26, 1985, and was completed on or after that date, or<br>(b) With respect to which a binding contract to incur significant expenditures was entered into before September 26, 1985, and part or all of such expenditures were incurred on or after that date.<br>Significant expenditures would be defined as expenditures in excess of 10% of the estimated cost of the facility. Facilities eligible for the exception would be defined as property for which bond financing was approved by a governmental unit (or by voter referendum) before September 26, 1985. | *Effective date.*—Bonds issued after the date of enactment.<br>*Exceptions.*—(1) Obligations with respect to facilities—<br>(a) The original use of which commences with the taxpayer and the construction, reconstruction, or rehabilitation of which began before March 1, 1986 and was completed on or after that date, or<br>(b) With respect to which a binding contract to incur significant expenditures was entered into before March 1, 1986 and part or all of such expenditures were incurred on or after that date.<br>Significant expenditures would be defined as expenditures in excess of 10% of the estimated cost of the facility. Facilities eligible for the exception would be defined as property for which bond financing was approved by a governmental unit (or by voter referendum) before March 1, 1986. |
| | | | (2) Refundings of bonds (a) that were issued before January 1, 1986 (including a series of refundings); (b) that are governmental bonds under present law; and (c) that could not be originally issued under the House bill, if—<br>(i) The amount of the refunding bonds did not exceed the outstanding amount of the refunded bonds; and<br>(ii) The refunding bonds (or series of refundings) did not have a maturity date later than the date which is the later of (a) 120% of the economic life of the property identified as being financed with the original (refunded) bonds when issued, or (b) 17 years after issuance of the original bonds. | (2) Refundings of bonds (a) that were issued before date of enactment (including a series of refundings); (b) that are governmental bonds under present law; and (c) that could not be originally issued under the proposal, if—<br>(i) The amount of the refunding bonds did not exceed the outstanding amount of the refunded bonds; and<br>(ii) The refunding bonds (or series of refundings) did not have a maturity date later than the date which is the later of (a) 120% of the economic life of the property identified as being financed with the original (refunded) bonds when issued, or (b) 17 years after issuance of the original bonds. |

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| B. Tax-Exempt Bonds for Certain Nongovernmental Activities<br>1. Industrial development bonds<br>*a. Exempt-activity IDBs* | (a) Exempt-activity IDBs are bonds the proceeds of which are to be used to finance— | (a) The President's proposal includes no exceptions to the governmental use requirement based on the activity being financed. | (a) Present law would be modified to permit interest on limited amounts of nongovernmental bonds to continue to be tax-exempt if bond proceeds were used to finance the following exempt facilities— | (a) Similar to present law, exempt-activity IDBs would be available to finance— |
| | (i) *Multifamily rental housing—* | (i) No tax exemption; | (i) *Multifamily rental housing—* | (i) *Multifamily rental housing—*<br>Same as House bill, except— |
| | (A) At least 20 percent (15 percent in targeted areas) of the housing units must be occupied by persons whose income does not exceed 80 percent of the area median income when they first rent the unit; and | | (A) One of the following set-aside requirements is satisfied on a continuous basis:<br>(1) At least 25 percent of the housing units are occupied by persons whose income does not exceed 80 percent of the area median income; or<br>(2) At least 20 percent of the housing units are occupied by persons whose income does not exceed 70 percent of the area median income.<br>Treasury Department would be required to make annual reports on compliance with (A) above. | (A) The qualified project period would last for a minimum of 12 years; and<br>(B) If a project ceased to comply with the low-income set-aside because of existing tenant income increases, the requirement that available units be rented to new low-income tenants would apply only to available units of comparable size to those occupied by the tenants whose income has increased.<br>(*See also*, the Real Estate title for details on a new low-income housing tax credit, Part XVI.C.2.) |
| | (B) Must be used for rental housing for a "qualified project period," generally 10 years or 50 percent of the term of the bonds with the longest maturity; | | (B) Must be used for rental housing for a "qualified project period," generally the longer of 15 years or the date on which bonds are no longer outstanding with respect to the project;<br>(C) Operator of project must certify to Treasury annually that project currently is in compliance with Code requirements;<br>(D) Low-income tenants would continue to be counted as such unless their incomes increased to an amount in excess of 120% of the applicable low-income ceiling; and<br>(E) If a project ceased to comply with the low-income set-aside because tenant incomes increased, no penalties would be imposed if each available unit after the noncompliance occurred were rented to a new low-income tenant until the project again was in compliance.<br>If noncompliance with (A), above, is not corrected after it reasonably should have been discovered, interest on bond financing would be nondeductible to project owner from first day of year in which noncompliance commenced until correction occurred. | |
| | Treasury regulations require that the determination in (A), above, be made with adjustments for family size, for bonds issued after 1985. | | Clarification would be made that the determinations in (A), above, are made with adjustments for family size. | |

## XVII. TAX-EXEMPT BONDS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| | (ii) *Sports facilities;* | (ii) No tax exemption; | (ii) Same as President's proposal; | (ii) Same as President's proposal; |
| | (iii) *Convention or trade show facilities;* | (iii) No tax exemption; | (iii) Same as President's proposal; | (iii) Same as President's proposal; |
| *a. Exempt-activity IDBs (cont.)* | (iv) *Airports,* defined to include runways, terminals, and other public facilities, as well as certain airport hotels and commercial facilities, hangars for one or more airlines, other property not available for use by the general public, and related storage and training facilities. | (iv) No tax exemption; | (iv) *Airports,* defined as ground facilities directly related to the transportation by air of passengers and cargo (includes runways, air traffic control towers, terminal facilities, public parking, and airline hangers, but not airport hotels, food preparation facilities, and shops). | (iv) *Airports,* defined as under present law, except that tax-exempt financing would not be available for hotels. |
| | (v) *Docks and wharves* and related storage and training facilities; | (v) No tax exemption; | (v) *Dock and wharf facilities* directly related to the transportation of passengers and cargo by water (excludes storage warehouses used other than in immediate transportation of goods). | (v) *Dock and wharf facilities,* defined as under present law. |
| | (vi) *Mass commuting facilities* and related storage and training facilities; | (vi) No tax exemption; | (vi) *Mass commuting facilities* defined generally as under present law; | (vi) Same as President's proposal. |
| | (vii) *Parking facilities;* | (vii) No tax exemption; | (vii) Same as President's proposal; | (vii) Same as President's proposal. |
| | (viii) *Sewage disposal facilities;* | (viii) No tax exemption; | (viii) *Sewage disposal facilities,* defined generally as under present law; | (viii) *Sewage disposal facilities,* defined as under present law. |
| | (ix) *Solid waste disposal facilities;* | (ix) No tax exemption; | (ix) *Solid waste disposal facilities,* defined generally as under present law; | (ix) *Solid waste disposal facilities,* defined as under present law. |
| | (x) *Electric energy and gas furnishing facilities* serving areas not exceeding 2 contiguous counties or a city and one contiguous county; | (x) No tax exemption; | (x) Same as President's proposal; | (x) *Electric energy and gas-furnishing facilities,* defined as under present law. |
| | (xi) *Certain facilities for the furnishing of water* (including irrigation systems); | (xi) No tax exemption; | (xi) *Certain facilities for the furnishing of water,* defined generally as under present law except excluding irrigation systems; | (xi) *Certain facilities for the furnishing of water,* defined as under present law (including irrigation systems). |
| | (xii) *Certain hydroelectric generating facilities* (expired generally after December 31, 1985); | (xii) No tax exemption; | (xii) Same as President's proposal; | (xii) Same as President's proposal, except retain and clarify transition rule included in present-law sunset date. |
| | (xiii) *Local district heating or cooling facilities,* and | (xiii) No tax exemption; and | (xiii) Same as President's proposal; and | (xiii) Same as President's proposal. |
| | (xiv) *Air or water pollution control facilities.* | (xiv) No tax exemption. | (xiv) Same as President's proposal. | (xiv) Same as President's proposal. |

## XVII. TAX-EXEMPT BONDS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| *a. Exempt-activity IDBs (cont.)* | | | *Effective date.*—Bonds issued after December 31, 1985.<br>*Exceptions.*—(1) Obligations with respect to facilities—<br>(i) The original use of which commences with the taxpayer and the construction, reconstruction, or rehabilitation of which began before September 26, 1985, and was completed on or after that date, or<br>(ii) With respect to which a binding contract to incur significant expenditures was entered into before September 26, 1985, and part or all of such expenditures were incurred on or after that date.<br>Significant expenditures would be defined as expenditures in excess of 10% of the estimated cost of the facility. Facilities eligible for the exception would be defined as property for which bond financing was approved by a governmental unit (or by voter referendum) before September 26, 1985.<br>(2) Refunding of IDBs (1) that were issued before January 1, 1986 (including a series of refundings), (2) that may be issued under present law, and (3) that could not be originally issued under the House bill, if—<br>(i) The amount of the refunding bonds did not exceed the outstanding amount of the refunded bonds;<br>(ii) The refunding bonds (or series of refundings) did not have a maturity date later than the date which is the later of (a) 120% of the economic life of the property financed with the original (refunded) bonds, or (b) 17 years after issuance of the original bonds. | *Effective date.*—Bonds issued after date of enactment.<br>*Exceptions.*—(1) Obligations with respect to facilities—<br>(i) The original use of which commences with the taxpayer and the construction, reconstruction, or rehabilitation of which began before March 1, 1986, and was completed on or after that date, or<br>(ii) With respect to which a binding contract to incur significant expenditures was entered into before March 1, 1986, and part or all of such expenditures were incurred on or after that date.<br>Significant expenditures would be defined as expenditures in excess of 10% of the estimated cost of facility. Facilities eligible for the exception would be defined as property for which bond financing was approved by a governmental unit (or by voter referendum) before March 1, 1986.<br>(2) Refunding of IDBs (1) that were issued before date of enactment (including a series of refundings), (2) that may be issued under present law, and (3) that could not be originally issued under the proposal, if—<br>(i) The amount of the refunding bonds did not exceed the outstanding amount of the refunded bonds;<br>(ii) The refunding bonds (or series of refundings) did not have a maturity date later than the date which is the later of (a) 120% of the economic life of the property financed with the original (refunded) bonds, or (b) 17 years after issuance of the original bonds. |

### XVII. TAX-EXEMPT BONDS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| ***b. Miscellaneous restrictions on exempt-activity IDBs*** | | | | |
| *i. Use of bond proceeds for activity qualifying for tax-exempt financing* | (b)(i) Only 90 percent of IDB proceeds are required to be used for purpose of bond issue; the remaining 10 percent may be used for any purpose.<br>In the case of exempt-activity IDBs, all property that is "functionally related and subordinate to" the exempt activity may be financed with bond proceeds and counts towards satisfaction of the 90 percent requirement. | (b)(i) No tax exemption for nongovernmental bonds. | (b)(i) All proceeds of nongovernmental bonds for exempt facilities (other than costs of issuance and proceeds invested in a reasonably required debt service reserve fund) would be required to be used for the activity qualifying the interest on the bonds for tax-exempton.<br>*Effective date.*—Bonds issued after December 31, 1985. | (b)(i) Same as present law, except change 90 percent to 95 percent. (i.e., 5% of the proceeds could be used for any purpose).<br>*Effective date.*—Bonds issued after date of enactment. |
| *ii. Ownership of property financed with nongovernmental bonds for exempt facilities* | (ii) Property financed with private activity bond proceeds may be owned by persons other than State or local governmental units. | (ii) No tax exemption for nongovernmental bonds. | (ii) Airports, docks and wharves, and mass commuting facilities would be required to be governmentally owned, determined using general Federal income tax rules.<br>*Effective date.*—Bonds issued after December 31, 1985.<br>Transitional exceptions similar to those provided for exempt facility bonds (item B.1.a., above). | Same as present law. |
| ***c. Industrial park IDBs*** | (c) Interest is tax-exempt on IDBs to be used to finance acquisition or development of land as a site for an industrial park. | (c) No tax exemption for nongovernmental bonds. | (c) Same as President's proposal.<br>*Effective date.*—Bonds issued after December 31, 1985.<br>Transitional exceptions similar to those provided for exempt facility bonds. | (c) Same as President's proposal.<br>*Effective date.*—Bonds issued after date of enactment.<br>Transitional exceptions similar to those provided for exempt-activity IDBs. |
| ***d. Small-issue IDBs*** | (d) Interest on small-issue IDBs is tax-exempt. Small-issue IDBs are issues not exceeding $1 million, the proceeds of which generally may be used to finance land or any depreciable property. The $1 million size limitation is increased to $10 million if an election is made to take certain capital expenditures into account.<br>Ninety percent of small-issue bonds must be used for the purpose of the borrowing.<br>A special rule allows small issue bonds to be used for first-time farmers to finance the purchase of farmland and for a *de minimis* amount of used equipment acquired in conjunction with the purchase of farmland by such farmers.<br>This exception expires generally after December 31, 1986 (December 31, 1988, in the case of bonds to finance manufacturing facilities). | (d) No tax exemption for nongovernmental bonds. | (d) Generally, the same as present law, except scheduled sunset dates deleted and all bond proceeds (other than costs of issuance and proceeds invested in a reasonable debt service reserve fund) required to be used for purpose of borrowing.<br>*Effective date.*—Bonds issued after December 31, 1985. | (d) Same as present law, except<br>(i) sunset for all small-issue bonds deferred until December 31, 1988.<br>(ii) 90% use rule increased to 95%, and<br>(iii) first-time farmer exception would be expanded to include farmers who qualify at time of purchase except for prior ownership of land disposed of through an insolvency proceeding, and to increase the amount of used equipment that may be financed to 25% of the financing provided to a qualifying farmer.<br>*Effective date.*—Bonds issued after date of enactment. |

## XVII. TAX-EXEMPT BONDS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **2. Student loan bonds** | Tax-exemption is permitted for interest on student loan bonds issued in connection with the Department of Education's Guaranteed Student Loan program. | No tax exemption for nongovernmental bonds. | Same as present law except expanded to include certain non-GSL student loan bonds and all bond proceeds (other than costs of issuance and amounts invested in a reasonable reserve fund) required to be used for purpose of making student loans.<br>*Effective date.*—Bonds issued after December 31, 1985. | Same as present law. |

## XVII. TAX-EXEMPT BONDS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **3. Mortgage revenue bonds**<br>*a. Qualified mortgage bonds and mortgage credit certificates* | (a)(1) Qualified mortgage bonds must be used to finance mortgages on single-family, owner-occupied residences. The targeting requirements for these bonds include the following:<br>(i) At least 90 percent of the lendable proceeds of each issue must be used to finance loans to first-time homebuyers;<br>(ii) The purchase price of bond-financed residences may not exceed 110 percent (120 percent in target areas) of the average area purchase price applicable to that residence; and<br>(iii) Issuers must publish and submit to the Treasury annual reports of their policies on the use of bond proceeds. | (a)(1) No tax exemption for nongovernmental bonds. | (a)(1) Interest on qualified mortgage bonds would continue to be tax-exempt. The present-law targeting requirements would be modified as follows:<br>(i) All bond proceeds (50% in targeted areas) other than issuance costs and amounts invested in reasonably required reserve fund would be required to be used to finance residences for first-time homebuyers;<br>(ii) The purchase price of bond-financed residences could not exceed 90 percent (110 percent in targeted areas) of the average area purchase price applicable to that residence;<br>(iii) Present-law requirement of annual Treasury reports would be deleted; and<br>(iv) At least 50 percent of the mortgage financing would be required to be provided to borrowers whose family income did not exceed 90 percent of higher of area or Statewide median income, and all such financing would be required to be provided to borrowers whose income did not exceed 115 percent of area median income.<br>In targeted areas, ½ of the financing could be provided to borrowers without regard to the above income limits; the balance of the financing would have to be provided to mortgagors having incomes not exceeding 140 percent of the higher of area or Statewide median income. | (a)(1) Same as present law. |
|  | (2) Issuers of qualified mortage bonds may elect to exchange part or all of their bond authority for authority to issue Mortgage Credit Certificates (MCCs). The aggregate principal amount of MCCs may not exceed 20 percent of the exchanged bond authority. MCCs generally are subject to the same targeting requirements as qualified mortgage bonds. | (2) The MCC option would be repealed along with authority to issue qualified mortgage bonds. | (2) Authority to issue MCCs would be continued. The targeting requirements for MCCs would be conformed to the revised targeting rules for qualified mortgage bonds. | (2) Same as present law, except increase trade-in rate from 20 percent to 25 percent. |
|  | (3) Authority to issue both qualified mortgage bonds and MCCs terminates after December 31, 1987. |  | (3) Same as present law. | (3) Delete sunset dates on qualified mortgage bond and MCC programs. |
|  |  |  | *Effective date.*—Bonds issued and MCCs issued with respect to bond authority exchanged after December 31, 1985. (Would not apply to mortgage loans made with the proceeds of bonds issued before January 1, 1986.) | *Effective date.*—Bonds issued and bond authority exchanged after date of enactment. |

## XVII. TAX-EXEMPT BONDS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| *b. Qualified veterans' mortgage bonds* | (b) Qualified veterans' mortgage bonds are bonds 90% or more of the proceeds of which are used to finance loans to veterans for the purchase of single-family, owner-occupied residences. Tax-exempt qualified veterans' mortgage bonds may be issued only by the five States that issued such bonds before June 22, 1984. Mortgage loans financed with those bonds may be made only to veterans who served on active duty before 1977 and who apply for a loan before 30 years after leaving active service. | (b) No tax exemption for nongovernmental bonds. | (b) Same as present law, except consistent with rules for other nongovernmental bonds, all bond proceeds (other than issuance costs and reasonably required reserve funds) would be required to be used for mortgage loans to qualified veterans.<br>*Effective date.*—Bonds issued after December 31, 1985. | (b) Same as present law. |
| **4. Tax-exempt bonds for section 501(c)(3) organizations** | Interest on bonds for nonprofit organizations described in Code section 501(c)(3) generally is tax-exempt. Bonds the proceeds of which are to be used by these organizations are subject to the same requirements as bonds for general government operations. Examples of organizations benefiting from these bonds are private, nonprofit hospitals and private, nonprofit colleges and universities. | No tax exemption for nongovernmental bonds. | Tax-exempt bonds for section 501(c)(3) organizations would be permitted, as follows:<br>(i) Only activities directly related to the exempt purpose of the organization could be financed (for example, a hospital could not finance a doctor's office building), and all bond proceeds (other than costs of issuance and proceeds invested in a reasonably required debt service reserve fund) would be required to be used for such activities;<br>(ii) In the case of section 501(c)(3) organizations other than hospitals, the aggregate amount of outstanding bonds of which each organization was a beneficiary could not exceed $150 million. (Generally, rules of the present $40 million limitation on beneficiaries of IDB-financing would be applied under this provision); and<br>(iii) All property financed with proceeds of these bonds would have to be owned by a section 501(c)(3) organization or governmental unit (using Federal income tax concepts of ownership).<br>*Effective date.*—Bonds issued after December 31, 1985.<br>Transitional exceptions similar to those provided for exempt facility bonds (item B.1.a., above). | Same as House bill, except 95 percent of proceeds rather than 100 percent would have to be used for qualified activities.<br>*Effective date.*—Bonds issued after date of enactment.<br>Transitional exceptions similar to those provided for exempt-activity IDBs (item B.1.a., above). |

## XVII. TAX-EXEMPT BONDS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **5. Qualified redevelopment bonds** | No specific provision, but bonds violating IDB or private loan bond restrictions are taxable. | Same as present law. | Would treat bonds to finance certain land acquisition and redevelopment in blighted areas, and for use by nongovernmental persons, as nongovernmental bonds. | Would treat bonds to finance certain land acquisition and redevelopment in blighted areas, and for use by nongovernmental persons, as tax-exempt IDBs. |
| ***a. General rule*** | | | (a) Qualified redevelopment bonds must be part of an issue:<br>(i) all net proceeds of which are used for redevelopment purposes in a locally designated blighted area, and<br>(ii) with respect to which incremental property tax revenues (i.e., additional tax revenues attributable to increased property values by reason of bond-financed redevelopment) are reserved exclusively for debt service on the issue, to the extent necessary to cover such debt service. | (a) Same as House bill, except 95 percent of proceeds would be required to be used for redevelopment purposes in a locally designated blighted area. |
| | | | Real property taxes in the designated area must be imposed at the same rate and in the same manner as for similar property located elsewhere in the jurisdiction. No additional fees or charges could be imposed in the designated area that were not imposed on other similar property in the jurisdiction. | Same as House bill. |
| ***b. Uses of bond proceeds*** | | | (b)(1) The proceeds of qualified redevelopment bonds could be used for the following purposes: | (b)(1) The proceeds of qualified redevelopment IDBs could be used for the following purposes: |
| | | | (i) To acquire by eminent domain, clear, and prepare land in a designated blighted area for redevelopment, and transfer real property interests to nongovernmental persons for fair market value; | (i) Same as House bill, but clarify that "fair market value" includes covenants and restrictions relating to the use of the real property. |
| | | | (ii) To rehabilitate or otherwise redevelop the real property (acquired as above); and | (ii) Same as House bill. |
| | | | (iii) To relocate occupants of structures on the acquired real property. | (iii) Same as House bill. |
| | | | (2) Qualified redevelopment bond proceeds could not be used to construct buildings or other new structures for use by nongovernmental persons on the bond-financed property. | (2) Same as House bill. |

## XVII. TAX-EXEMPT BONDS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| *c. Designation of blighted areas* | | | (c)(1) Qualified redevelopment bonds could be issued only pursuant to—<br>(i) a State law that authorizes the issuance of such bonds for permitted purposes in blighted areas, and<br>(ii) a redevelopment plan adopted (before issuance of the bonds) by the governing body of the general purpose local governmental unit having jurisdiction over the blighted area. | (c)(1) Same as House bill. |
| | | | (2) Designation of blighted areas would be made by the general purpose local governmental unit. This designation would be based on prescribed State statutory criteria. | (2) Same as House bill. |
| | | | (3) The aggregate blighted areas designated by a local governmental unit could not contain real property, the assessed value of which is more than 10 percent of the assessed value of all real property within its jurisdiction. | (3) Same as House bill, but increase to 25 percent and clarify that value of property in redevelopment districts is determined on date of designation for purposes of this requirement. |
| | | | (4) A designated blighted area would have to be larger than a contiguous ¼-square mile. | (4) A designated blighted area could not be smaller than 15 contiguous acres. |
| *d. Application of IDB limitations* | | | (d)(1) Qualified redevelopment bonds would be subject to the volume and other limitations applicable to nongovernmental bonds, except the limitation on use of bond proceeds to acquire land. | (d)(1) Qualified redevelopment bonds would be IDBs and hence subject to all IDB restrictions, including the volume limitation for IDBs and student loan bonds. An exception would be provided from the limitation on the use of bond proceeds to acquire land. |
| | | | (2) Owner-occupied housing rehabilitated with qualified redevelopment bond proceeds, or constructed on bond-financed land, would be permitted only if—<br>(i) the first purchaser of each residence reasonably expected it to be his or her principal residence, and<br>(ii) the residence satisfied the purchase price limitation which would apply for qualified mortgage bonds in the same location. | (2) No restriction. |

## XVII. TAX-EXEMPT BONDS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| *d. Application of IDB limitations (cont.)* | | | (3) Residential rental housing rehabilitated with qualified redevelopment bond proceeds, or constructed on bond-financed land, would have to satisfy all Code requirements applicable to multifamily residential rental housing, throughout the qualified project period as defined for bond purposes. | (3) No restriction. |
| | | | (4) Facilities that may not be financed with IDBs may not be located on land financed with qualified redevelopment bonds. | (4)(a) Except as provided in (b), no more than 25 percent of the total bond proceeds for a redevelopment district could be used for facilities with respect to which tax-exempt financing is restricted or for land on which such facilities were to be located.<br>(b) The following facilities could not be financed with redevelopment bonds or located on land financed with such bonds:<br>(i) Private or commercial golf courses;<br>(ii) Country clubs;<br>(iii) Massage parlors, hot tub facilities, or suntan facilities; and<br>(iv) Racetracks and other facilities primarily used for gambling. |

BEST COPY AVAILABLE

## XVII. TAX-EXEMPT BONDS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| 6. Miscellaneous restrictions on tax-exempt bonds | | | | |
| *a. Restriction on maturity of nongovernmental bonds* | (a) The weighted average maturity of IDBs many not exceed 120 percent of the economic life of the bond-financed property. | (a) No tax exemption for nongovernmental bonds. | (a) Extend present-law restriction to all nongovernmental bonds (other than mortgage subsidy bonds and student loan-bonds).<br>*Effective date.*—Bonds issued after December 31, 1985. | (a) Extend present-law restriction to section 501(c)(3) organization bonds. |
| *b. Acquisition of land and existing property and prohibition on financing certain facilities* | (b) Interest on IDBs generally is taxable if more than 25 percent of the proceeds of an issue is used for land. Acquisition of existing property may not be financed with tax-exempt IDBs unless a rehabilitation requirement is satisfied.<br>Luxury boxes and certain other facilities may not be financed with tax-exempt bonds. | (b) No tax exemption for nongovernmental bonds. | (b) Extend present-law restrictions to all nongovernmental bonds (other than mortgage subsidy bonds).<br>*Effective date.*—Bonds issued after December 31, 1985. Transitional exceptions (for bonds not presently subject to these limitations) similar to those provided for section 501(c)(3) organization bonds in item B.4., above. | (b) Same as present law. |
| *c. Public approval requirement* | (c) IDBs may be issued only after the issuer holds a public hearing and the bonds are approved by an elected official. Alternatively, issuance of the bonds may be approved by a voter referendum. | (c) No tax exemption for nongovernmental bonds. | (c) Extend present IDB requirements to all nongovernmental bonds.<br>*Effective date.*—Bonds issued after December 31, 1985. | (c) Same as present law. |
| *d. Change in use of nongovernmental bond-financed property* | (d) Tax-exempt bonds generally are not required to be redeemed if the use of bond-financed property changes from a use qualifying interest on the bonds for tax-exemption to a nonqualified use. | (d) No tax exemption for nongovernmental bonds. | (d) A change in the use of property financed with nongovernmental bonds, to a use not qualifying for tax-exempt financing, generally would result in loss of income tax deductions for rent, interest, or equivalent amounts paid by the person using the property in the nonqualifying use. Section 501(c)(3) organizations would realize unrelated business income with respect to such use. These consequences would apply in addition to any loss of tax exemption on bond interest provided under present law.<br>*Effective date.*—Changes in use occurring after December 31, 1985, with respect to financing provided (by loan, lease, or other arrangement) after that date. | (d) Same as House bill.<br>*Effective date.*—Changes in use occurring after date of enactment, with respect to financing provided (by loan, lease, or other arrangement) after that date. |

## XVII. TAX-EXEMPT BONDS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **C. Volume Limitations on Nongovernmental Bonds** | *Volume Limitations*<br>Three separate sets of volume limitations are imposed under present law with respect to certain types of nongovernmental bonds.<br>*(1) Limitation on student loan bonds and most IDBs*<br>*Aggregate volume.*—The amount of student loan bonds and most IDBs that may be issued within a State during any calendar year is limited to the greater of $150 for each resident of the State or $200 million.<br>The $150 per capita limitation is scheduled to be reduced to $100 after 1986 to reflect the scheduled sunset of most small-issue IDBs. | No tax exemption for nongovernmental bonds. | *Unified Volume Limitation*<br>A single volume limitation would be imposed with respect to the following bonds issued by States and local issuers therein—<br>(1) All nongovernmental bonds with respect to which tax-exemption was permitted (except certain airport facility bonds, discussed below); and<br>(2) The portion of a governmental bond issue in excess of $1 million that was used by persons other than a State or local government.<br>*Aggregate volume.*—The annual volume of tax-exempt nongovernmental bonds (including the nongovernmental portion of governmental bonds, discussed in (2), above) issued by each State and local issuers therein could not exceed the greater of $175 per resident of the State or $200 million.<br>This per capita limitation would be reduced to $125 per resident after 1987 to reflect the present-law scheduled sunset of tax-exemption for qualified mortgage bonds.<br>Current refunding bonds would not be subject to the volume limitation to the extent the amount of the refunding bonds did not exceed the amount of outstanding refunded bonds and did not have a maturity date after expiration of 120% of the economic life of the bond-financed property (17 years for nonfacility bonds and 32 years for tax-exempt mortgage bonds). | *Volume Limitations*<br>Three separate sets of volume limitations would be imposed similar to present law—<br>*(1) Limitation on student loan bonds and most IDBs*<br>Same as present law, except multifamily housing bonds and qualified redevelopment bonds would be subject to the cap and scheduled 1986 reduction in cap to $100 per capita would be deferred until December 31, 1988. |
|  | *Allocation rates.*—Each State's volume limitation is allocated one-half to State issuers and one-half to localities within the State on the basis of relative populations unless the State adopts a statute providing a different allocation. Governors of each State are permitted to issue proclamations overriding the Federal rules during an interim period before State legislatures meet. Each person allocating bond authority must certify that the allocation is not made in consideration of any bribe, gift, or campaign contribution. (A special allocation rule applies for States having constitutional home rule cities.) |  | *Allocation rules.*—Each State's volume limitation would be allocated one-half to State issuers and one-half to localities within the State on the basis of relative populations unless the State adopted a statute providing a different allocation. Governors of each State would be permitted to issue proclamations overriding the Federal allocation rules, effective during an interim period before State legislatures meet. The present-law required certification by persons allocating bond authority would be repealed. Other administration provisions of the present IDB volume limitation (including the rules for determining the location of property receiving volume allocations, and the special rule for State having constitutional home rule cities) would apply under the new volume limitation. |  |

XVII. TAX-EXEMPT BONDS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **C. Volume Limitations on Nongovernmental Bonds (cont.)** | *Carryforward of bond authority.*—Bond issuers may elect to carry forward unused bond authority (for up to three years generally) for specific, identified exempt-activity IDB projects, or for the general purpose of issuing student loan bonds.<br>*(2) Qualified mortgage bonds*<br>*Aggregate volume.*—The annual volume of qualified veterans' bonds that may be issued within a State is limited to the greater of (1) 9 percent of the average annual aggregate principal amount of mortgages executed during the three preceding years for single-family, owner-occupied residences located in the State, or (2) $200 million.<br>*Allocation rules.*—Qualified mortgage bond authority is allocated among issuers in each State pursuant to rules like those applicable to student loan bonds and most IDBs.<br>*Carryforward of bond authority.*—States may not carry forward unused qualified mortgage bond authority. |  | *Carryforward of bond authority.*—Bond issuers could elect to carry forward unused bond authority for up to three years for specific, identified nongovernmental projects and for the general purpose of issuing either (a) qualified mortgage bonds or (b) qualified veterans' mortgage bonds.<br>*Permanent set-aside for section 501(c)(3) organization bonds.*—An amount equal to $25 per capita ($30 million for States having a $200 million limit) would be set-aside permanently for section 501(c)(3) organization bonds.<br>*Protection of housing bonds.*—Unless overridden by a State statute, at least 50% (reduced to 25% after 1987 to reflect the sunset of authority to issue qualified mortgage bonds) of each State's annual nongovernmental bond volume limitation would be required to be used for—<br>(i) multifamily rental housing bonds;<br>(ii) qualified mortgage bonds; or;<br>(iii) qualified veterans' mortgage bonds.<br>At least ⅓ of the housing portion would have to be used for multifamily houisng and ⅓ for single-family housing unless overridden by the governor or a State statute. | *(2) Qualified mortgage bonds*<br>Same as present law. |

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **C. Volume Limitations on Nongovernmental Bonds (cont.)** | *(3) Qualified veterans' mortgage bonds*<br>*Aggregate volume.*—The five States permitted to issue qualified veterans' mortgage bonds are subject to volume limitations based on the volume in which they issued bonds during the period beginning on January 1, 1979, and ending on June 22, 1984.<br>*Allocation rules.*—Qualified veterans' mortgage bonds are general obligation bonds of the issuing State. This bond authority is not allocated to any local governmental issuers.<br>*Carryforward of bond authority.*—States may not carry forward unused qualified veterans' mortgage bond authority. | | *Protection of qualified redevelopment bonds.*—Unless overridden by a State statute, at least $6 per capita or the equivalent would have to be set-aside for qualified redevelopment bonds in States that issued more than $25 million in tax-increment bonds between July 18, 1984 and January 1, 1986. | *(3) Qualified veterans' mortgage bonds*<br>Same as present law. |
| | *Nongovernmental Bonds Not Subject to Volume Limitations*<br>No volume limitations are imposed with respect to nongovernmental bonds the proceeds of which are to be used—<br>(1) By section 501(c)(3) organizations;<br>(2) For multifamily rental housing;<br>(3) For governmentally owned airports, docks and wharves, mass commuting facilities, convention centers, and trade show facilities. | | *Nongovernmental Bonds Not Subject to Volume Limitations*<br>Bonds to finance airports (other than cargo handling facilities) would not be subject to the volume limitation; bonds for port facilities (other than storage facilities) likewise would not be subject to the limitation. Tax-exempt financing for these facilities would not be permitted unless the facilities were governmentally owned, determined by reference to general income tax concepts of ownership. (See, B.1.b.ii., above.) | *IDBs, etc. Not Subject to Volume Limitations*<br>No volume limitations would be imposed with respect to—<br>(1) Section 501(c)(3) organization bonds,<br>(2) Bonds for airports, and docks and wharves, if the bond-financed property were governmentally owned, determined generally by reference to Federal income tax concepts of ownership.<br>(3) Bonds for qualified public sewage, solid waste disposal and water facilities, if—<br>(a) The facilities are owned by a governmental unit determined generally by reference to Federal income tax concepts (however, there would be no special restrictions on the terms of management contracts for such facilities); and<br>(b) The rates for the service are established or approved by a State or political subdivision thereof or a public service or public utility commission having continuing oversight over operation of the facility.<br>(Safeharbor rules similar to the rules that applied before enactment of ACRS would be adopted for determining when property was governmentally owned for purposes of this volume limitation exception.) |

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **C. Volume Limitations on Nongovernmental Bonds (cont.)** | | | *Effective date.*—Bonds issued after December 31, 1985.<br>*Exceptions.*—(1) Bonds presently subject to no State volume limitations but that would be subject to the new limitation, if the bonds were with respect to facilities—<br>(a) The original use of which commences with the taxpayer and the construction, reconstruction, or rehabilitation of which began before September 26, 1985, and was completed on or after that date, or<br>(b) With respect to which a binding contract to incur significant expenditures was entered into before September 26, 1985, and part or all of such expenditures were incurred on or after that date.<br>Significant expenditures would be defined as expenditures in excess of 10% of the estimated cost of the facility. Facilities eligible for the exception would be defined as property for which bond financing was approved by a governmental unit (or by voter referendum) before September 26, 1985.<br>(2) Bonds presently subject to State volume limitations that would be subject to the new single limitation to the extent that the bonds are issued pursuant to a carryforward election allowed under current State volume limitation filed before October 31, 1985, if the bonds are issued with respect to facilities satisfying the transitional exceptions in (1) (a) or (b), above. | *Effective date.*—Bonds issued after date of enactment.<br>*Exceptions.*—Bonds presently subject to no State volume limitations but that would be subject to the new limitation, if the bonds were with respect to facilities—<br>(a) The original use of which commences with the taxpayer and the construction, reconstruction, or rehabilitation of which began before March 1, 1986, and was completed on or after that date, or<br>(b) With respect to which a binding contract to incur significant expenditures was entered into before March 1, 1986, and was completed on or after that date.<br>Significant expenditures would be defined as expenditures in excess of 10% of the estimated cost of the facility. Facilities eligible for the exception would be defined as property for which bond financing was approved by a governmental unit (or by voter referendum) before March 1, 1986. |

## XVII. TAX-EXEMPT BONDS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **D. Arbitrage Restrictions**<br>**1. Profit limitations and determination of bond yield** | Present law includes three sets of arbitrage restrictions applicable to tax-exempt bonds.<br>*General restrictions applicable to all tax-exempt bonds*<br>*Profit limitations.*—If bond proceeds are reasonably expected to be invested in other securities (other than tax-exempt bonds) having a yield that is materially higher than the yield on the bonds, bond interest is taxable. The amount of permitted arbitrage earnings depends on whether the bond proceeds are invested in obligations related to the purpose of the borrowing or in other, nonpurpose obligations, and whether the issuer elects to earn unlimited arbitrage profits for certain temporary periods. | The present-law arbitrage rules would be modified as follows:<br>*General restrictions applicable to all tax-exempt bonds*<br>*Profit limitations.*—Clarification would be provided that the reasonable expectations test included in the present-law general arbitrage restrictions does not protect intentional acts to create arbitrage. | Same as President's proposal, with the following modifications:<br>*General restrictions applicable to all tax-exempt bonds*<br>*Profit limitations.*—The restriction on investment in higher yielding obligations would be expanded to include investment in annuity contracts and other property held for investment. (This rule would ensure that purchase of 3rd party contracts to fund deferred payment arrangements would be subject to yield restrictions in the same manner as direct funding of these arrangements.) | Same as present law, with the following modifications:<br>*General restrictions applicable to all tax-exempt bonds*<br>*Profit limitations.*—Same as House bill. |
| | *Exceptions.*—(1) Investments not exceeding a minor portion (15%) of bond proceeds in materially higher yielding obligations. (A reasonably required debt service reserve fund is the most important example of the use of this exception.)<br>(2) Investments during a temporary period prior to use for the purpose of the borrowing. (Generally, this temporary period may not exceed 3 years.) | *Exceptions.*—The right to elect to earn higher arbitrage profits over the entire term of the bonds by foregoing a temporary period when unlimited arbitrage is permitted would be repealed.<br>Temporary periods during which unlimited arbitrage is permitted would be restricted as follows:<br>(a) No temporary period would be permitted for bond issues to finance acquisitions; and<br>(b) For construction projects, the temporary period would end on the earlier of the date—<br>(i) The project was substantially completed;<br>(ii) An amount equal to bond proceeds had been spent on the project; or<br>(iii) Three years after the earlier of the date the bonds were issued or the date construction on the project began. | *Exceptions.*—The present-law minor portion rule would be deleted. The exception for reasonably required debt service reserve funds would be retained.<br>A 30 day temporary period would be permitted for bonds used to finance acquisitions.<br>The allowable temporary period for bonds used for mixed acquisition/construction projects would be determined separately with respect to the portion of the bond proceeds used for each activity. | *Exceptions.*—Same as present law except the minor portion (other than a reasonably required reserve fund) would be limited to the lesser of 5% of bond proceeds or $100,000. |
| | *Determination of bond yield.*—Bond yield is interpreted to mean the discount rate at which all anticipated payments of principal and interest on the bonds equals the net proceeds of the issue after deducting the costs of issuance. (This deduction of issuance costs permits bond issuers to earn a higher yield on the investment of bond proceeds, and thereby to pay issuance costs out of arbitrage profits.) | *Determination of bond yield.*—Bond yield is determined using the original issue discount rules of the Code. (Thus, costs of issuance may not be recovered out of arbitrage profits.) | | *Determination of bond yield.*—Same as President's proposal. |

BEST COPY AVAILABLE

## XVII. TAX-EXEMPT BONDS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **1. Profit limitations and determination of bond yield (cont.)** | *Additional restrictions for most IDBs*<br>*Profit limitations.*—IDBs (other than IDBs for multifamily rental housing) are subject to the following additional arbitrage restrictions:<br>(a) The amount of bond proceeds that may be invested at unrestricted yield in obligations unrelated to the purpose of the borrowing is limited to 150 percent of scheduled annual debt service.<br>(b) The gross earnings on each issue of bonds must be rebated to the Federal Government at specified intervals.<br>*Exceptions.*—The restriction on investment in nonpurpose obligations (item a, above) does not apply to investments for an initial temporary period or to investments for temporary periods related to current debt service (as opposed to reserve funds for future debt service).<br>The rebate requirement does not apply if all bond proceeds are spent for the governmental purpose of the issue within 6 months of issuance of the bonds or to certain debt service funds on which less than $100,000 is earned in a bond year. | *Extension of present-law additional IDB restrictions*<br>The present restriction on investment of bond proceeds in obligations unrelated to the purpose of the borrowing and the rebate requirements applicable to most IDBs would be extended to all tax-exempt bonds. | *Extensions of present-law additional IDB restrictions*<br>The present-law additional restrictions on most IDBs would be extended to all tax-exempt bonds other than qualified mortgage bonds and qualified veterans' mortgage bonds. | *Extension of present-law additional IDB restrictions.*<br>Same as House bill, except—<br>(1) Liberalize application of rebate rule to current debt service funds of governmental units with general taxing powers; and<br>(2) Provide an exception from the rebate requirement for bonds to finance operations of or facilities for governmental units with general taxing powers if all bonds issued by or on behalf of the unit in the year of issue are not reasonably expected to exceed $5 million. |
| | *Additional restrictions for qualified mortgage bonds*<br>*Profit limitations.*—The effective rate of interest on mortgage loans provided with qualified mortgage bonds may not exceed the yield on the issue by more than 1.125 percentage points.<br>Investment of qualified mortgage bond proceeds in obligations unrelated to the purpose of the borrowing is restricted in a manner similar to that for most IDBs. Additionally, arbitrage profits must be rebated to the Federal Government or paid or credited to the mortgagors.<br>*Exceptions.*—Exceptions similar to those to the additional restrictions on most IDBs are provided. | | *Additional restrictions for qualified mortgage bonds*<br>Qualified mortgage bonds would remain subject to the present law additional arbitrage restriction and rebate requirement that applies to those bonds in lieu of the expanded IDB-type restrictions. | *Additional restrictions for qualified mortgage bonds*<br>Same as present law. |
| | | | *Additional restrictions for veterans' mortgage bonds*<br>The present-law qualified mortgage bond additional arbitrage restriction and rebate requirement would be extended to qualified veterans' mortgage bonds in lieu of the expanded IDB-type restrictions. | *Additional restrictions for qualified veterans' mortgage bonds*<br>Same as House bill. |

## XVII. TAX-EXEMPT BONDS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| 1. Profit limitations and determination of bond yield (cont.) | | | | |
| | *Additional restrictions for student loan bonds*<br>In 1984, Treasury was directed to prescribe regulations applying additional arbitrage restrictions similar to those now applying to most IDBs to student loan bonds. | | *Additional restrictions for student loan bonds.*—Repeals present-law direction for special Treasury regulations to the extent inconsistent with new arbitrage restrictions imposed by the bill. | *Additional restrictions for student loan bonds.*—Same as House bill. |
| | *SLGS Program*<br>The Treasury Department issues a special State and Local Government Series (SLGS) of Treasury bonds to enable issuers of State and local government bonds to avoid impermissible arbitrage profits. Interest rates on SLGS are set by reference to the permitted yield on each issue of tax-exempt bonds. Purchasers of SLGS must give Treasury 20 days notice of their intent to purchase. The maturity of SLGS is set to match that of the tax-exempt bonds; the minimum maturity is 45 days. | | | *Modification of SLGS Program*<br>The Treasury Department would be directed to modify the SLGS program to provide (a) instruments allowing flexible investment of bond proceeds in a manner eliminating the earning of rebatable arbitrage, and (b) operation of the SLGS program at no net cost to the Government.<br>These new rules would permit demand deposits under the SLGS program by deleting advance notice requirements related to the purchase of SLGS and deleting minimum maturity requirements. |
| | | | *Effective dates.*—Bonds issued after December 31, 1985, except for the restriction on investment of bond proceeds in annuities and similar deferred compensation arrangements purchased from 3rd parties, which would apply to bonds issued after September 25, 1985. | *Effective dates.*—Bonds issued after date of enactment, except for the restriction on investment of bond proceeds in annuities and similar deferred compensation arrangements purchased from third parties, which would apply to bonds issued after September 25, 1985. |

BEST COPY AVAILABLE

## XVII. TAX-EXEMPT BONDS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **2. Prohibition of advance refundings** | Bonds other than IDBs and mortgage subsidy bonds may be advance refunded. IDBs and mortgage subsidy bonds may not be refunded more than 180 days before the refunded bonds are redeemed. An exception waives this 180-day rule in the case of refunded bonds having a maturity of less than three years. | Interest on advance refunding bonds would be taxable. Advance refundings would be defined to include all refundings where the refunded bonds were not redeemed immediately upon issuance of the refunding bonds. | Advance refundings would be defined as refundings where the refunded bonds are not redeemed within 30 days of issuance of the refunding bonds. | Advance refunding defined as refunding where the refunded bonds are not redeemed within 90 days of issuance of the refunding bonds. |
| | | | Up to two advance refundings would be permitted for governmental bonds, subject to certain restrictions (including being subject to new volume limitation for nongovernmental portion of such bonds). | Up to two advance refundings permitted for bonds other than IDBs, student loan bonds, mortgage revenue bonds, or other private loan bonds for which tax-exemption is permitted, subject to the following restrictions—<br>(1) no more than two sets of bonds (including the original bonds) could be outstanding at any one time;<br>(2) the temporary period for the refunding bonds ends no later than 30 days after the date of their issue;<br>(3) the temporary period for the refunded bonds ends on the date the refunding bonds are issued;<br>(4) in the case of advance refundings producing a debt service savings (determined without regard to issuance costs), refunded bonds would have to be retired on their first call date;<br>(5) the 150% limitation on nonpurpose investments would not apply to advance refundings; and<br>(6) rules would be included to preclude flip-flops and other abusive transactions through application of the arbitrage rebate rules.<br>(Under these rules, section 501(c)(3) organization bonds could be advance refunded in the same manner as bonds for the actual financing of government functions.) |
| | | | *Effective date.*—Bonds issued after December 31, 1985.<br>Transitional exception permitting advance refunding of pre-1986 section 501(c)(3) organization bonds and pre-1986 bonds that were governmental bonds when issued, but no longer qualify as such, subject to the new restrictions. | *Effective date.*—Bonds issued after date of enactment. |

## XVII. TAX-EXEMPT BONDS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **3. Restriction on early issuance of bonds** | No separate rules require that bond proceeds be spent within a specified period following issuance; however, issuers are required to proceed with "due diligence" to realize the governmental purpose of the borrowing. Additionally, arbitrage profits on most IDBs and on qualified mortgage bonds must be rebated to the Federal Government in certain cases. | Five percent or more of bond proceeds would be required to be spent for the purpose of the borrowing within 30 days after bond issuance. All bond proceeds (other than costs of issuance and amounts in a reasonably required reserve fund) would have to be spent no later than 3 years after bond issuance. | Same as the President's proposal, exempt would permit the Treasury to entend the 30-day or 3-year period during which bond proceeds were required to be spent in cases where undue hardship otherwise would result (i.e. where delay results from events such as Acts of God).<br>*Effective date.*—Bonds issued after December 31, 1985. | Same as present law. |
| **E. Information Reporting Requirement for All Tax-Exempt Bonds** | Issuers of private activity bonds (defined as IDBs, student loan bonds, and bonds for section 501(c)(3) organizations) and mortgage subsidy bonds are required to report certain information about volume and users of bond-financed facilities to the Treasury. | The present-law information reporting requirements for bonds other than mortgages subsidy bonds would be extended to all tax-exempt bonds. (The proposal includes no separate provision for reporting on mortgage subsidy bonds since tax-exemption for those bonds would be repealed.) | Same as the President's proposal, except for a modification providing that the present-law information reporting requirements for mortgage subsidy bonds would continue to apply to those bonds (in lieu of the private activity bond requirements).<br>*Effective date.*—Bonds issued after December 31, 1985. | Same as House bill.<br>*Effective date.*—Bonds issued after date of enactment. |
| **F. Special Transitional Exceptions** |  | No provisions. | Various special transitional exceptions. | No provision. |
| **G. General Stock Ownership Corporation Provisions** | A State may establish a General Stock Ownership Corporation (GSOC) that serves as an investment fund for its citizens. GSOCs may elect to be exempt from tax with the shareholders reporting as income their prorata share of the GSOC's taxable income. (No State has used this provision.) | Repeals the GSOC provision as "deadwood."<br>*Effective date.*—January 1, 1984. | Same as President's proposal. | Same as President's proposal. |

## XVIII. TRUSTS AND ESTATES; GENERATION-SKIPPING TRANSFERS

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **A. Income of a Minor Child** | | | | |
| **1. Unearned income of a minor child** | If income-producing assets are transferred to a minor child, income earned on those assets generally is taxed to the child at the child's marginal rate. | The proposal would tax unearned income of a child under 14 years of age to the child at the top marginal rate of the parents to the extent the income was attributable to property received from the parents. Earned income and unearned income derived from assets received from sources other than a parent that are placed in a qualified segregated account would be taxed at the child's marginal rate.<br>Property eligible to be placed in a qualified segregated account would include earned income, money or property received from someone other than the parents and property received by reason of a parent's death.<br>The proposal applies with respect to a child under 14 years of age who is eligible to be claimed as a dependent on the parents' return. | Same as President's proposal. | Special rules would be provided with respect to any child under 14 years of age.<br>In the case of a child under 14 years of age, unearned income is taxed to the child at the top marginal rate of the parents to the extent that unearned income exceeds the sum of $4,000 and any personal exemption allowable against unearned income (up to $1,000). The child's first $4,000 of unearned income in excess of the personal exemption allowable against unearned income (up to $1,000) is taxed to the child at the child's marginal rates. Thus, up to $5,000 of unearned income of a child under age 14 would be taxed essentially as under present law. An exception is provided for unearned income of segregated assets derived from earned income of the child or tort recoveries.<br>All income (earned and unearned) of a child over 13 years of age and all earned income of a child under 14 years of age is taxed to the child at the marginal rates of the child. |
| **2. Personal exemption and zero bracket amount** | With respect to eligible minor children, both the child and the parents may claim a personal exemption ($1,040 for 1985).<br>If a child is eligible to be claimed as a dependent on the parent's return, the child may apply the zero bracket amount ($2,390 for a single person for 1985) only against earned income. | Both the child and the parent may claim the increased personal exemption ($2,000).<br>A child eligible to be claimed as a dependent on the parents return may use the zero bracket amount (under the proposal, $2,900 for a single individual) against earned income and against unearned income derived from assets held in a qualified segregated account.<br>*Effective date.*—The proposal would apply for taxable years beginning after December 31, 1985. | The personal exemption amount allowed on such return may be used to offset no more than $1,000 of unearned income. An additional $1,000 of the personal exemption amount may be used to offset earned income, but only to the extent that earned income exceeds the standard deduction by that amount.<br>The standard deduction may be claimed on the return of a child eligible to be claimed as a dependent on the parent's return only to the extent that it may offset earned income.<br>*Effective date.*—Same as President's proposal. | Same as House bill.<br>*Effective date.*—Taxable years beginning after December 31, 1986. |

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **B. Income Taxation of Trusts and Estates**<br>**1. In general** | The income taxation of a trust depends on whether the trust is a grantor or nongrantor trust. In the case of a grantor trust (i.e., one where the grantor (or other person with the power to revoke the trust) has certain powers with respect to the trust), income is taxed directly to the grantor. In the case of a nongrantor trust, each trust is treated as a separate taxable entity. | As under present law, income of a grantor trust is taxed directly to the grantor. However, the President's proposal revises the definition of a grantor trust.<br>During the lifetime of the grantor, all income of any nongrantor trusts generally would be taxed to the trust at the top marginal rate of the grantor. | Limits the scope of the grantor trust rules and continues to tax the income of a grantor trust directly to the grantor.<br>Nongrantor trusts generally are taxed at the top marginal rate of the grantor. In addition, special rules may permit the use of lower rates where the trust's beneficiaries are minor children of the grantor.<br>In addition, in the case of a qualified beneficiary trust, income generally is taxed to the trust at the top marginal rate of the beneficiary.<br>Foreign trusts are taxed under the present law rules. | Nongrantor trusts and estates would be taxed as under present law, except that the tax brackets applicable to such trusts and estates would be narrowed.<br>As under present law, income of a grantor trust is taxed directly to the grantor. However, the definition of a grantor trust would be revised to include trusts which return to the grantor or the grantor's spouse. |
| **2. Trusts other than grantor trusts** | *Applicable rate.*—Each nongrantor trust separately calculates its tax liability as a separate taxable entity at the rates applicable to a married person filing separately. | *Applicable rate.*—Each nongrantor trust is taxable as a separate taxable entity at the top marginal rate of the grantor. | *Applicable rate.*—Under the proposal, the income of a nongrantor trust generally is taxed at the top marginal rate of the grantor. Unlike the President's proposal, the rate is determined by applying any unused rate bracket amount allocated to the trust by the grantor. For example, if the grantor has $20,000 of unused rate bracket amount in the 35% bracket in a particular year, the grantor could allocate that amount to any trust he had created. The trust would be taxed at 35% on the first $20,000 of income and 38% on any income in excess of $20,000.<br>If no unused rate bracket amounts are allocated to a trust for a particular year, the income of the trust is taxed at the top marginal rate (38%).<br>*Qualified beneficiary trust.*—In the case of a qualified beneficiary trust, the income of the trust is taxed at rates determined by using the unused rate bracket amount of the beneficiary. A qualified beneficiary trust is one where all of the trust income and corpus may be used only for distributions to, or for the benefit of, the beneficiary or his estate. A qualified beneficiary trust also includes any QTIP trust.<br>Where a trust has more than one grantor, each portion of the trust attributable to a particular grantor generally is treated as a separate trust for Federal tax purposes. However, married individuals may elect to be treated as a single grantor. | *Applicable rate.*—Undistributed income of both existing and newly created nongrantor trusts would be taxed at the following rates:<br>$0–$5,000 .......... 15%<br>$5,000–$10,000 .......... 25%<br>$10,000 or more .......... 35% |

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| 2. Trusts other than grantor trusts (cont.) | *Calculation of tax liability.*—In calculating tax liability—<br>(1) the personal exemption is limited to $100 or $300;<br>(2) no zero bracket amount is permitted;<br>(3) an unlimited charitable deduction is available; and<br>(4) a distribution deduction generally is allowed for distributions to beneficiaries. | *Calculation of tax liability.*—In calculating tax liability, the President's proposal generally follows present law except that—<br>(1) no personal exemption is allowed, and<br>(2) a distribution deduction is allowed during the lifetime of the grantor only for certain mandatory distributions and only if the grantor has not retained a disqualifying interest.<br>*Mandatory distributions.*—Mandatory distributions generally include—<br>(1) A fixed or ascertainable amount of trust income or property required by the terms of the trust to be distributed to a specific beneficiary or beneficiaries (whether or not actually distributed); and<br>(2) Amounts irrevocably set aside for a beneficiary, provided the amount set aside is required to be distributed ultimately to the beneficiary or the beneficiary's estate, and the beneficiary agrees to include currently in income the amount set aside.<br>*Disqualifying interest.*—If the grantor retains a disqualifying interest, then no distribution deduction will be permitted, even for mandatory distributions. A grantor has a disqualifying interest—<br>(1) if any person other than the grantor or the grantor's spouse possesses the discretionary power to make payments of trust property to the grantor or the grantor's spouse;<br>(2) if any portion of the trust may revert to the grantor or the grantor's spouse, unless the reversion cannot occur prior to the death of the income beneficiary of such portion and such beneficiary is younger than the grantor, or prior to the expiration of a term of years that is greater than the life expectancy of the grantor at the creation of the funding of the trust;<br>(3) if any person has the power exercisable in a nonfiduciary capacity to control trust investments, to deal with the trust for less than full and adequate consideration, or to exercise any general administrative power in a nonfiduciary capacity without the consent of a fiduciary; | *Calculation of tax liability.*—In calculating tax liability, the bill generally follows the President's proposal except that—<br>(1) a personal exemption of $100 is allowed, and<br>(2) a distribution deduction is not allowed at any time. | *Calculation of tax liability.*—Same as present law. |

### XVIII. TRUSTS AND ESTATES; GENERATION-SKIPPING TRANSFERS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **2. Trusts other than grantor trusts (cont.)** | | (4) if and to the extent that, an otherwise deductible mandatory distribution satisfies a legal obligation of the grantor or grantor's spouse, including a legal obligation of support or maintenance; or<br>(5) if, trust income or corpus can be used to carry premiums on life insurance policies on the life of the grantor or the grantor's spouse with respect to which the grantor or the grantor's spouse possesses any incident of ownership. | | |
| | *Aggregation of trusts.*—Pursuant to Treasury regulations, two or more trusts will be treated as a single trust if (1) the trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and (2) a principal purpose of the use of separate trusts is the avoidance of Federal income tax. | *Aggregation of trusts.*—Under the proposal, during the lifetime of the grantor, income of all trusts created by the grantor (in the case of joint return, the grantor and the grantor's spouse) generally will be aggregated with the grantor's income (in the case of a joint return, the sum of the grantor's and the spouse's income) to determine the marginal tax rate applicable to the trust. The total tax then must be allocated to each trust proportionately on the basis of taxable income. | *Aggregation of trusts.*—Same as the President's proposal, except that it simplifies the aggregation by permitting the grantor (or designated beneficiary) to allocate unused rate bracket amounts. In addition, where trust beneficiaries are minor children of the grantor, it permits the children to allocate their unused rate bracket amounts to the trust, effectively subjecting some or all of the trust income to an effective tax rate lower than that of the grantor. | *Aggregation of trusts.*—Same as present law. |
| **3. Taxation of trusts after the death of the grantor** | Under present law, there is no distinction between the taxation of a trust during the grantor's lifetime or after his death. | For all taxable years beginning after the grantor's death, each trust established by the grantor must compute separately taxable income. Tax liability is computed using the rate schedule applicable to married individuals filing separately; with no zero bracket amount, no personal exemption and a deduction for all distributions actually made. | After the death of the grantor, the trust determines its tax by taking into account any rate bracket amount allocated to the trust under the grantor's will. If the grantor's will does not provide for an allocation of his rate bracket amounts, his rate bracket amounts are allocated among all the trusts created by the grantor in proportion to their values for estate tax purposes. | Same as present law, except for rates set forth above (in item 2). |
| **4. Taxation of distributions to beneficiaries** | *In general.*—Distributions to beneficiaries are taxed to beneficiaries and deductible by the trust to the extent of the distributable net income (DNI) of the trust.<br>*Tier System.*—DNI is allocated first to distributions that are required to be made out of income for the year, secondly to distributions made to charity out of trust income, and lastly to other distributions. | As under current law, distributions to beneficiaries that are deductible to the trust would be taxable to beneficiaries. However, the tier rules would be repealed and each recipient would take into account a proportionate share of DNI. | Repeals the DNI rules, exempts all distributions from the recipient beneficiary's income, and provides special basis rules for property distributed in kind. | Same as present law. |

## XVIII. TRUSTS AND ESTATES; GENERATION-SKIPPING TRANSFERS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **5. Taxation of previously accumulated income** | Distributions to beneficiaries out of previously accumulated income are taxed to beneficiaries under a throwback rule designed to tax the income upon distribution at the beneficiaries' average marginal rate in the previous five years. | The throwback rules continue to apply and would be expanded to apply to income accumulated while a beneficiary was under 21 years of age.<br>In addition, the President's proposal suggests that it may be appropriate to impose an interest charge on the tax payable with respect to an accumulation distribution. | Repeals the throwback rules. | Same as present law. |
| **6. Grantor trusts** | Under certain circumstances, the grantor (or other person having the power to revoke the trust) is taxed directly on trust income.<br>*The grantor.*—The grantor generally is treated as the owner of all or a portion of the trust if (1) the grantor has a reversionary interest expected to return to him within ten years; (2) the grantor has the power to control beneficial enjoyment of the income or corpus; (3) the grantor retains certain administrative powers; (4) the grantor retains the right to revoke the trust at any time during the first ten years of the trust's existence; or (5) the income of the trust may be distributed to the grantor or the grantor's spouse during the first ten years of the trust's existence.<br>*Persons other than the grantor.*—A person other than the grantor is treated as the owner of all or a portion of the trust if (1) that person has the power to revoke the trust, or (2) that person surrendered the power to revoke and that person retained one of the powers listed above. | The President's proposal limits the circumstances under which a grantor would be treated as the owner of the trust. A grantor would be taxed directly on trust income only if:<br>(a) payments of trust property are required to be made to or for the benefit of, the grantor or the grantor's spouse;<br>(b) payments may be made to or for the benefit of the grantor or the grantor's spouse—<br>(i) under a discretionary power to make payments, or<br>(ii) by exercise of a power to revoke or amend the trust, which power is in the grantor or the grantor's spouse;<br>(c) the grantor or the grantor's spouse has any power to cause the trustee to lend trust income or corpus to either of them without adequate security and interest; or<br>(d) the grantor or the grantor's spouse has borrowed trust income or corpus and has not completey repaid the loan or any interest thereon before the beginning of the taxable year. | The grantor trust rules are modified so that they apply only where there are (1) certain administrative powers which permit indirect control over the trust assets, (2) a power to revoke, or (3) a power to control income. | The grantor trust rules would be modified to delete the 10-year exception of present law and to treat powers and interests of the grantor's spouse as powers and interests of the grantor. |

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| 7. Estates | A decedent's estate is treated as a separate taxable entity, beginning as of the date of death. The estate may elect a taxable year different than the decedent's taxable year.<br>Under present law, an estate is allowed a $600 personal exemption and otherwise computes its tax liability generally in the same manner as a nongrantor trust, except that the throwback rules do not apply. | The President's proposal would—<br>(1) provide that an estate would be treated as a separate taxable entity;<br>(2) require the estate to adopt the same taxable year as the decedent;<br>(3) subject an estate to tax at a separate rate schedule, with no personal exemption and no zero bracket amount, but with a deduction for distributions to beneficiaries;<br>(4) exempt any estate with less than $600 of gross income from Federal tax liability; and<br>(5) continue the taxable year of the decedent after his death as if the decedent died on the last day of his taxable year.<br>*Effective date.*—The President's proposal generally would apply to irrevocable trusts created after December 31, 1985, and to trusts that are revocable on January 1, 1986, for taxable years beginning on or after that date.<br>If additional amounts are contributed after December 31, 1985, to a trust that is irrevocable on that date, the trust would be treated as created after that date.<br>For other trusts that are irrevocable on December 31, 1985, certain of these rules will apply, with modifications. | Under the bill—<br>(1) an estate is treated as a separate taxable entity required to adopt the same taxable year as the decedent;<br>(2) an estate is taxable at the same rates as a single individual, calculated without a zero bracket amount but with a personal exemption of $600; and<br>(3) no distribution deductions are allowed.<br>*Effective date.*—The provision generally applies to irrevocable trusts created after September 25, 1985, and to trusts that are revocable on September 25, 1985, for taxable years beginning on or after that date.<br>If additional amounts are contributed after September 25, 1985, to a trust that is irrevocable on that date, that trust is treated as created after that date.<br>Other trusts that are irrevocable on September 25, 1985, continue to be subject to tax under present law. | As under present law, the undistributed income of both existing and newly created estates for taxable years beginning more than 2 years after the decedent's death would be taxed according to the rates applicable to nongrantor trusts (See item 2, above).<br>The rate for the first two taxable years would be the rate of a married person filing separately.<br>*Effective date.*—The rate changes are effective for taxable years beginning after December 31, 1986. The changes in the grantor trust rules are effective for transfers in trust made after March 1, 1986. |

## XVIII. TRUSTS AND ESTATES; GENERATION-SKIPPING TRANSFERS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| C. Generation-Skipping Transfer Tax | A generation-skipping transfer tax (GST tax) is imposed on transfers under a trust or similar arrangement having beneficiaries in more than one generation below that of the grantor of the trust. Subject to certain transition rules, the GST tax applies to transfers occurring after June 11, 1976. | A separate Treasury Department proposal, introduced in the 98th Congress, would modify the GST tax as follows: | The previously introduced Treasury proposal would be adopted with the following modifications: | Retain present law. |
| 1. Taxable transfers | The GST tax is imposed on taxable terminations under and taxable distributions (other than income) from a trust or a similar arrangement in which beneficiaries in more than one generation younger than that of the grantor have an interest (or certain powers over the property) (i.e., generation-sharing arrangements). Direct transfers to persons more than one generation below that of the grantor are not subject to GST tax (i.e., direct skips). | The modified GST tax would be imposed on taxable terminations and taxable distributions (including distributions of income) under generation-sharing arrangements, as under present law. Taxable beneficiaries would include only persons having interests in (as opposed to powers over) property. Direct skips would be subject to tax. | Same as Treasury proposal, except a provision would be added under which direct skips to grandchildren would not be treated as generation-skipping transfers if the grandchild's parent who was a lineal descendant of the transferor was deceased when the transfer occurred. | Retain present law. |
|  | In the case of trusts having beneficiaries assigned to three or more younger generations GST tax is imposed on the termination of the interests (or powers) of each of the intermediate younger generations (when the trust property is not subject to gift or estate tax). | In the case of trusts having beneficiaries assigned to three or more younger generations, GST tax would be imposed only on the termination of the oldest such generation. | Same as present law. |  |
| 2. Exemption from tax | There is no specific exemption or credit that a grantor may apply against GST tax; however, if a generation-skipping transfer occurs at or after the deemed transferor's death, any unused portion of the deemed transferor's gift and estate tax unified credit may be applied against GST tax. Additionally, a special $250,000 per deemed transferor exemption is permitted for transfers to grandchildren. | A specific exemption of $1 million per transferor would be provided in lieu of the present credit and grandchild exclusion. The specific exemption would be transferable between spouses. Rules would be provided for allocation of unused exemption amounts remaining after the death of a transferor.<br>Under special rule, certain trust beneficiaries could receive up to $10,000 per year in generation-skipping transfers free of GST tax. | Same as the Treasury proposal except generation-skipping transfers by married individuals would be treated as made one-half by each spouse pursuant to rules similar to the present gift tax rules on such gifts to third persons; the additional $10,000 exemption for distributions to certain generation-skipping beneficiaries would be deleted; and a special $2 million per grandchild exemption would be provided for direct skips. | Retain present law. |
| 3. Tax rate | The GST tax is imposed at the gift or estate tax rate that would be imposed if the property were transferred to the beneficiary by a deemed transferor (generally, the parent of the beneficiary.) GST tax on taxable terminations is determined on a tax-inclusive basis (like the estate tax) and taxable distributions are taxed on a tax-exclusive basis (like the gift tax). | All generation-skipping transfers would be subject to tax at a flat rate, equal to 80 percent of the maximum gift and estate tax rate. GST tax on transfers under generation-sharing arrangements would be determined on a tax-inclusive basis; tax would be determined on a tax-exclusive basis on direct skips. | All generation-skipping transfers would be subject to tax at a flat rate, equal to the maximum gift and estate tax rate (presently, 55%; scheduled to decline to 50% in 1988). GST tax would be determined as provided in the Treasury proposal. | Retain present law. |

## XVIII. TRUSTS AND ESTATES; GENERATION-SKIPPING TRANSFERS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| 4. Credit for State taxes | A limited credit against GST tax is permitted for State death taxes imposed on generation-skipping transfers (based on the deemed transferor concept). | A credit against GST tax would be permitted equal to 5 percent of State taxes on generation-skipping transfers. | Same as Treasury proposal. | Retain present law. |
| 5. Effective dates | | | The amended GST tax would apply to transfers after the date of enactment, subject to the following exceptions:<br>(1) Inter vivos transfers occurring after September 25, 1985, would be subject to the amended tax;<br>(2) Transfers from trusts that were irrevocable before September 26, 1985, would be exempt to the extent that the transfers were not attributable to additions to the trust corpus occurring after that date; and<br>(3) Transfers pursuant to wills in existence before September 26, 1985, would not be subject to tax if the decedent was incompetent on that date and at all times thereafter until death.<br>The present GST tax would be repealed, retroactive to June 11, 1976. | Retain present law. |

## XIX. MISCELLANEOUS PROVISIONS

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **A. Expiring Provisions** | | | | |
| **1. Tax credit for orphan drug clinical testing** | A 50-percent tax credit is allowed for a taxpayer's expenses of clinical testing of certain drugs for rare diseases or conditions. The credit is scheduled to expire after 1987. | Same as present law (i.e., credit expires after 1987). | The tax credit for clinical testing of orphan drugs is extended for one additional year (i.e., through December 31, 1988). | Same as present law (i.e., credit expires after 1987). |
| **2. Expensing for costs of removing architectural barriers to the handicapped and elderly** | Taxpayers may elect to deduct up to $35,000 of qualifying expenses for the removal of architectural and transportation barriers to the handicapped and elderly in the year paid or incurred, instead of capitalizing them. The election is not available in taxable years beginning after December 31, 1985. | No provision. | The election to deduct qualifying expenditures is extended for two years, to taxable years beginning before January 1, 1988. | The election to deduct qualifying expenditures would be extended permanently, effective for taxable years beginning after December 31, 1985. |
| **3. Rules for spouses of Vietnam MIAs** | Certain tax relief provisions applicable with respect to Vietnam MIAs and their spouses expired after 1982 (secs. 2(a)(3)(B), 692(b), 6013(f)(1), and 7508(b)). | No provision. | The bill reinstates and makes permanent the expired provisions relating to Vietnam MIAs, effective for taxable years beginning after 1982. | Same as House bill. |
| **4. Targeted jobs tax credit** | A tax credit is available on an elective basis to employers of individuals from nine targeted groups, i.e., individuals who are recipients of payments under means-tested transfer programs, economically disadvantaged (as measured by family income), or disabled. The credit generally equals 50 percent of the first $6,000 of qualified first year wages and 25 percent of the first $6,000 of qualified second year wages. A credit equal to 85 percent of up to $3.000 of wages of any disadvantaged summer youth employee also is allowed. The employer's deduction for wages must be reduced by the amount of the credit.<br>Under present law, the credit will not apply with respect to targeted-group individuals who begin work for the employer after December 31, 1985. | No provision. | The targeted jobs credit is extended for two additional years with several modifications: the credit for second-year wages is eliminated, the first-year credit reduced to 40 percent of the first $6,000 of qualified first-year wages (except in the case of disadvantaged youth employees), the credit for wages paid to an individual who works for the employer for fewer than 14 days is eliminated, and the authorization for appropriations for administrative and publicity expenses is extended through fiscal year 1987.<br>*Effective date.*—Taxable years beginning after 1985. | The targeted jobs credit would be extended for two additional years, with modifications. The credit for second-year wages would be eliminated, as would the credit for wages paid to an individual who works for the employer for fewer than 14 days. Also, the authorization for appropriations for administrative and publicity expenses would be extended through fiscal year 1987.<br>*Effective date.*—Taxable years beginning after 1985. |

### XIX. MISCELLANEOUS PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **B. Olympic Trust Fund and Excise tax** | No provision. (Various earmarked excise taxes are dedicated to specific trust funds.) | No provision. | *(1) Excise tax.*—A 10-percent excise tax is imposed on amounts paid for U.S. television and radio broadcast rights for Olympic games.<br>*Effective date.*—Amounts paid after November 22, 1985, other than pursuant to binding contracts in effect on that date. Any inconsistent U.S. treaty provision is overriden.<br>*(2) Olympic Trust Fund.*—An Olympic Trust Fund is established in the Treasury to receive amounts from the new excise tax. Trust fund monies are available, less related Treasury administrative expenses, to be paid to the U.S. Olympic Committee for Olympic-related expenses.<br>*Effective date.*—Date of enactment. | Same as House bill. |

BEST COPY AVAILABLE

## XIX. MISCELLANEOUS PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **C. Exempt Organizations**<br>**1. Exchanges and rentals of membership lists of certain tax-exempt organizations** | Charitable and other tax-exempt organizations are subject to tax on income from an unrelated trade or business (the UBIT), i.e., where the conduct of the business is not substantially related to the exempt functions of the organization.<br>The U.S. Court of Claims has held that income received by the Disabled American Veterans from other exempt organizations and commercial businesses for the use of its mailing lists is subject to the UBIT. | No provision. | The bill provides an exemption from the UBIT, in the case of certain tax-exempt organizations eligible to receive charitable contributions, for income from exchanges or rentals of mailing lists with or to other such organizations.<br>*Effective date.*—On enactment. | Same as House bill. |
| **2. Distribution of low-cost articles by charities** | Charitable and other tax-exempt organizations are subject to tax on income from an unrelated trade or business (the UBIT), i.e., where the conduct of the business is not substantially related to the exempt functions of the organization.<br>Under Treasury regulations, the UBIT does not apply where an organization "sends out low cost items incidental to the solicitation of charitable contributions." | No provision. | The bill provides an exemption from the UBIT, in the case of certain tax-exempt organizations eligible to receive charitable contributions, for income from certain distributions of low-cost articles incidental to soliciting charitable contributions.<br>*Effective date.*—On enactment. | Same as House bill. |
| **3. Tax exemption for certain title-holding companies** | A corporation organized to hold title to property, and to distribute the income therefrom to one or more tax-exempt organizations, may itself be tax exempt. The IRS has taken the position that such a title-holding company is not tax exempt if it also distributes income to unrelated organizations. | No provision. | No provision. | The exemption for title-holding companies would apply where the corporation (a) has no more than 35 shareholders, (b) has only one class of stock or beneficial interest, and (c) is operated for the exclusive purpose of holding title to property and distributing income to eligible shareholders.<br>The latter term would include<br>(i) a qualified pension plan,<br>(ii) a governmental pension plan,<br>(iii) any State or political subdivision, or<br>(iv) any tax-exempt charitable organization (sec. 501(c)(3)).<br>*Effective date.*—Taxable years beginning after 1986. |

## XIX. MISCELLANEOUS PROVISIONS—(Continued)

| Item | Present Law | President's Proposal | House Bill | Chairman's Proposal |
|---|---|---|---|---|
| **D. Allocation of Housing Cooperative Interest and Taxes** | A tenant-stockholder in a cooperative housing corporation is entitled to deduct his or her "proportionate share" of the housing cooperative's expenses for interest and taxes.<br>The tenant-stockholder's proportionate share is the portion of the cooperative's interest and taxes that bears the same ratio to the cooperative's total expenses for interest and taxes that the portion of the cooperative's stock held by the tenant-stockholder bears to the total outstanding stock of the cooperative. | No provision. | Cooperative housing corporations that charge tenant-stockholders with a portion of the cooperative's interest and taxes in a manner that reasonably reflects the cost to the cooperative of the interest and taxes allocable to each tenant-stockholder's dwelling unit, may elect to have such tenant-stockholders deduct the separately allocated amounts.<br>*Effective date.*—Taxable years beginning after December 31, 1985. | Same as House bill. |
| **E. Foster Care Payments** | A foster parent may exclude from gross income certain reimbursements for expenses of caring for a foster child placed in the home by a government agency or a State-licensed, tax-exempt child placement agency. To obtain the exclusion, the foster parents must account for all expenses incurred for each foster child in their care. | No provision. | The present-law exclusion is modified to eliminate the requirement of detailed recordkeeping.<br>*Effective date.*—Taxable years beginning after 1985. | Same as House bill. |